

Cite as Det. No. 14-0329, 35 WTD 113 (2016)

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

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| In the Matter of the Petition for Correction of ) | <u>D E T E R M I N A T I O N</u> |
| Assessment of )                                   |                                  |
| )   | No. 14-0329                      |
| )   |                                  |
| . . . )   | Registration No. . . .           |
| )   |                                  |

[1] RULE 106; RCW 82.04.040: B&O TAX – SHARED-LOSS PAYMENTS – CASUAL AND ISOLATED SALE. Shared-loss payments received by a bank from the FDIC are income received as a result of losses suffered in the taxpayer’s banking business and are, therefore, not income from a casual and isolated sale. Moreover, the shared loss payments did not result from any “sale” made by the taxpayer, as the taxpayer was actually the buyer of defunct banks.

[2] RCW 82.04.090; RCW 82.04.080: B&O TAX – SHARED-LOSS PAYMENTS – VALUE PROCEEDING OR ACCRUING – GROSS INCOME OF THE BUSINESS – MERE ACCOUNTING ENTRIES – RETURN OF PRINCIPAL – REALIZATION OF GAINS – INSURANCE PROCEEDS. Shared-loss payments received by a bank from the FDIC constitute value proceeding and accruing to a taxpayer and are not mere accounting entries, a return of principal, the realization of gains, or insurance proceeds.

[3] RULE 14601: B&O TAX – SHARED-LOSS PAYMENTS – APPORTIONMENT. Shared-loss payments received by a bank from the FDIC arose from the taxpayer’s continuing operation of defunct banks it purchased from the FDIC. Therefore, for purposes of apportioning taxpayer’s income for periods prior to June 1, 2010, the shared-loss payments should be assigned to the location where the taxpayer services the loans that gave rise to the shared-loss payments.

[4] RULE 19404: B&O TAX – SHARED-LOSS PAYMENTS – APPORTIONMENT. Shared-loss payments received by a bank from the FDIC arose from the taxpayer’s continuing operation of defunct banks it purchased from the FDIC. The shared-loss agreements giving rise to the shared-loss payments are not “investment assets” and the shared-loss payments should be assigned to the location where the taxpayer services the loans that gave rise to the shared-loss payments.

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.

Weaver, A.L.J. – A taxpayer bank petitions for the correction of an assessment of service and other activities business and occupation (B&O) taxes on “shared-loss” payments it received from the Federal Deposit Insurance Corporation (FDIC). The FDIC took over three failing banks and sold those banks to Taxpayer under an agreement where the FDIC would compensate Taxpayer when a certain threshold number of loans Taxpayer acquired from the failing banks went into default. Taxpayer argues that the shared-loss payments it received from the FDIC were not taxable in Washington. Taxpayer’s petition is denied.<sup>1</sup>

### ISSUES

1. Whether, under WAC 458-20-106, shared-loss payments received from the FDIC are tax-exempt as related to the casual and isolated sales of the failed banks.
2. Whether, under RCW 82.04.080 and WAC 458-20-146, shared-loss payments received from the FDIC constitute gross income of the recipient bank’s business.
3. Whether, under RCW 82.04.090, shared-loss payments received from the FDIC are a return of principal and therefore do not constitute “consideration.”
4. Whether, under RCW 82.04.080, WAC 458-20-146, and WAC 458-20-162, shared-loss payments received from the FDIC are gains realized from trading in stocks, bonds, or other evidences of indebtedness.
5. Whether, under WAC 458-20-257, shared-loss payments received from the FDIC are exempt from tax as insurance proceeds.
6. Whether, under WAC 458-20-14601 and WAC 458-20-19404, shared-loss payments received from the FDIC are “investment assets” that should be assigned to the out-of-state corporate headquarters for purposes of apportionment.

### FINDINGS OF FACT

[Taxpayer] is an operating subsidiary of [Corporation], which has its headquarters [out of state]. Taxpayer is a financial institution in the business of making and servicing loans, providing savings and checking accounts, and investing in securities. . . . Taxpayer entered into three separate transactions with the Federal Deposit Insurance Corporation (FDIC) . . . .

In connection with each of the three acquisitions, Taxpayer entered into Purchase and Assumption Agreements with the FDIC. The Purchase and Assumption Agreements provide that Taxpayer assumed various liabilities of the Defunct Banks, like assumed deposits, liabilities for indebtedness secured by mortgages or similar security arrangements, borrowings from Federal Reserve Banks or similar institutions, and interest on deposit liabilities. In addition, Taxpayer purchased from the FDIC all right, title, and interest to all assets of the Defunct Banks, with the exception of certain selected assets excluded from the Purchase and Assumption Agreements. As part of the Purchase and Assumption Agreements, Taxpayer agreed to continue full service

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

banking in the trade area of the Defunct Banks, including processing credit card transactions, maintaining safe deposit boxes, paying all drawn checks, and other banking services.

Article IV, Paragraph 4.15 of the Purchase and Assumption Agreements provide that:

4.15 Agreement with Respect to Loss Sharing. [Taxpayer] shall be entitled to require reimbursement from the Receiver [FDIC] for loss sharing on certain loans in accordance with the Single-Family Shared-Loss Agreement attached hereto as Exhibit 4.15A and the Non-SF Shared-Loss Agreement attached hereto as Exhibit 4.15B, collectively the “Shared-Loss Agreements.”

Under these Shared-Loss Agreements, the FDIC agreed to pay Taxpayer for losses suffered on acquired mortgage loans upon the occurrence of various specified events, and Taxpayer agreed to reimburse the FDIC for amounts received if Taxpayer subsequently recovered the losses from borrowers. Each Purchase and Assumption Agreement with the FDIC consisted of a separate Shared-Loss Agreement for acquired mortgages on commercial properties and another Shared-Loss Agreement for mortgages on single-family homes. Losses were measured differently based on the circumstances of the various mortgage loans,<sup>2</sup> and the Shared-Loss Agreements imposed a threshold for cumulative losses before any payments are made by the FDIC. When loss threshold amounts were met, Taxpayer received shared-loss payments from the FDIC.

More specifically, the Purchase and Assumption Agreement defined the concept of the “First Loss Tranche,” as “the dollar amount of liability that [Taxpayer] will incur prior to the commencement of loss sharing, which is the sum of (i) [Taxpayer’s] asset premium (discount bid), as reflected on the [Taxpayer’s] bid form, plus (ii) [Taxpayer’s] Deposit premium bid, as reflected on [Taxpayer’s] bid form, plus (iii) the Equity Adjustment. The “Equity Adjustment” was the difference between the Book Value as of closing of all assumed liabilities and the purchase price of all assets at closing. Taxpayer submitted an asset discount bid of (\$ . . . ) and a positive Deposit premium bid of 1%. Once the First Loss Tranche was satisfied, the FDIC was required to begin remitting amounts to Taxpayer under the Shared-Loss Agreements.

For example, the Single-Family Shared-Loss Agreement provided that once the “Shared Loss Payment Trigger” was met, the FDIC would pay Taxpayer 80% of the “Monthly Shared-Loss Amount” reported by Taxpayer. Once the “Stated Threshold” was reached (\$ . . . of losses under the Shared-Loss Agreements), the FDIC was required to remit payments equal to 95% of the Monthly Shared-Loss Amount. The Shared-Loss Agreement provided that the “Shared Loss Payment Trigger” occurred when the Cumulative Loss Amount under both Shared-Loss Agreements exceeded the First Loss Tranche, with Cumulative Loss Amount being the sum of all “Monthly Loss Amounts,” less the sum of all “Recovery Amounts.” “Monthly Loss Amounts” consisted of the sum of six different types of specified losses subject to recovery (foreclosure losses, restructuring losses, short sale losses, portfolio losses, modification default losses, and losses in connection with deficient valuations). “Recovery Amounts” consisted of any amounts collected by Taxpayer (i) against a foreclosure loss previously paid by the FDIC to Taxpayer, (ii) gains realized from a sale of portfolio loans for which Taxpayer received a

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<sup>2</sup> Losses generally include uncollected payments and other revenue deficiencies resulting from foreclosures, restructured loans and portfolio sale losses.

restructuring loss from the FDIC, and (iii) any incentive payments from national programs paid to an investor or borrower that have been modified or treated under the FDIC Loan Modification Program. In summary, the Loss Sharing Arrangement reimbursed Taxpayer for 80-95% of its reported Monthly Loss Amounts for a ten-year period.

For financial accounting purposes, Taxpayer treated the assets and liabilities assumed from the transactions separately from the Shared-Loss Agreements. The acquired loans were initially recorded by Taxpayer at their “fair market value,” which incorporated credit risks associated with the loans, and the Shared-Loss Agreements were separately recorded as indemnification assets. For federal income tax purposes, Taxpayer accounted for the Defunct Bank acquisitions as taxable transactions pursuant to 26 U.S.C. § 597; however, the Shared-Loss Agreements and related payments from the FDIC (the “FDIC Payments”) were not recognized as taxable assets because they are considered “federal financial assistance” under 26 U.S.C. § 597. The Payments were instead realized by Taxpayer in connection with recognizing gains and losses on indemnified loans. Taxpayer never reported the Payments as Washington income. Taxpayer states that the reason it did not report the Payments was that it essentially treated them as recouped losses from borrowers on underperforming loans.

The Department’s Audit Division examined Taxpayer’s records for the period January 1, 2008 and March 31, 2012. During that time, Taxpayer operated . . . branches in the State of Washington, including all the acquired branches of Bank I and Bank II. The acquired branches of Bank III were all located [outside of Washington]. In its examination, the Audit Division found \$ . . . in unreported Payments that Taxpayer received from the FDIC under the Shared-Loss Agreements.<sup>3</sup>

The Audit Division identified which FDIC Payments were received pursuant to the Bank I and Bank II acquisitions and assigned those FDIC Payments as Washington income. FDIC Payments received pursuant to the Bank III acquisition were assigned as . . . income. On September 4, 2013, the Audit Division issued Assessment No. . . . , in the amount of \$ . . . , which included \$ . . . in service and other B&O tax, \$ . . . in interest, an interest reconciliation of \$ . . . , a 5% assessment penalty of \$ . . . , less a payment of \$ . . . made on August 27, 2013. Taxpayer filed a timely appeal.

## ANALYSIS

The B&O tax is imposed for the privilege of engaging in business in Washington. RCW 82.04.220. The term “business” includes “all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or another person or class, directly or indirectly.” RCW 82.04.140. The measure of the tax is the gross proceeds of sales or the gross income of the business. RCW 82.04.220. The tax at issue here is the applicability of the service and other activities B&O tax imposed by RCW 82.04.290(2) to the FDIC Payments received by Taxpayer pursuant to the Shared-Loss Agreements relating to Bank I and Bank II.

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<sup>3</sup> Because Taxpayer never reported the Washington FDIC Payments to the Department, it never paid Washington tax on the Payments.

Exemptions from a taxing statute must be narrowly construed. *Budget Rent-A-Car, Inc. v. Dep't. of Revenue*, 81 Wn.2d 171, 174, 500 P.2d 764 (1972); *Evergreen-Washelli Memorial Park Co. v. Dep't. of Revenue*, 89 Wn.2d 660, 663, 574 P.2d 735 (1978). Statutory tax exemptions and tax deductions must be strictly construed in favor of application of the tax. As stated in *Budget Rent-A-Car, Inc. v. Dep't. of Revenue*, 81 Wn.2d 171, 174-75, 500 P.2d 764 (1972), “[e]xemptions to the tax law must be narrowly construed. Taxation is the rule and exemption is the exception. The taxpayers have the burden of proving qualification for tax exemptions or deductions. *Group Health Co-op. v. Tax Comm’n*, 72 Wn.2d 422, 43 P.2d 201 (1967). *Tesoro Refining & Marketing Co. v. Dep’t of Revenue*, 164 Wn.2d 310, 317, 189 P.3d 28 (2008).

Taxpayer argues that the FDIC Payments it received pursuant to the Shared-Loss Agreements should not be subject to B&O tax for various reasons. We address these arguments in turn.

### **I. The FDIC Payments Do Not Arise from A Casual and Isolated Sale.**

Taxpayer’s first argument asserts that the Payments are exempt from B&O tax because they originate from the acquisition of Bank I and Bank II, and that those acquisitions qualify as casual or isolated sales. Under RCW 82.04.040, a “casual or isolated” sale is defined to mean “a sale made by a person who is not engaged in the business of selling the type of property involved.” RCW 82.04.040(2). WAC 458-20-106 (Rule 106) explains that the business and occupation tax does not apply to casual or isolated sales. Specifically, Rule 106 provides:

A casual or isolated sale is defined by RCW 82.04.040 as a sale made by a person who is not engaged in the business of selling the type of property involved. Any sales which are routine and continuous must be considered to be an integral part of the business operation and are not casual or isolated sales . . . .

Rule 106. Taxpayer argues that the FDIC’s transfer of the Defunct Banks’ assets to Taxpayer constituted a “casual and isolated sale,” because the FDIC is not a “person engaged in business of selling the type of property involved.” Taxpayer then argues that because the FDIC Payments derived from the original Purchase and Assumption Agreements, those receipts are all part of the FDIC’s casual and isolated sale of the Defunct Banks to Taxpayer. We are not persuaded by Taxpayer’s arguments . . . .

. . .

. . . By buying the Defunct Banks, Taxpayer became entitled to various income streams related to the operation of the Defunct Banks’ accounts. Taxpayer was entitled to receive payments on the Defunct Banks’ commercial and residential mortgages, interest income on the Defunct Banks’ bank accounts, fees from processing credit card transactions, fees for maintaining safe deposit boxes, and revenues from other routine banking services. Taxpayer also became entitled to FDIC Payments when certain loss threshold amounts were met. . . . The FDIC Payments are simply an income stream that Taxpayer is entitled to receive through its operation of the Defunct Banks [and such payments do not involve a casual and isolated sale of property]. The FDIC Payments are continuous and routine rights to payment, no different from the other banking income Taxpayer became entitled to receive after purchasing the Defunct Banks . . . .

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## II. The FDIC Payments Are Gross Income of Taxpayer's Business.

Taxpayer's second argument is that the FDIC Payments are not taxable income, because they do not constitute any "value proceeding or accruing" to Taxpayer as defined in RCW 82.04.090. RCW 82.04.080 defines "gross income of the business," in pertinent part, as:

[T]he 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.

RCW 82.04.080 (emphasis added). RCW 82.04.090 defines "value proceeding or accruing" as "the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued . . . ." RCW 82.04.090 (emphasis added). Taxpayer has various theories why the FDIC Payments do not constitute "consideration." We address those arguments in turn.

### A. The FDIC Payments Are Actual Receipts, Not Mere Accounting Entries.

Taxpayer argues that WAC 458-20-146 (Rule 146) authorizes it to treat the Payments as it would for financial accounting purposes which results in the FDIC Payments being excluded from the measurement of B&O tax. Taxpayer cites the following language of Rule 146 to justify its position that the accounting methods utilized by banks can be relied upon for purposes of determining gross income:

**When tax liability arises.** Tax should be reported during the reporting period in which the financial institution receives, becomes legally entitled to receive, or in accord with the system of accounting regularly employed enters the consideration as a charge against the client, purchaser or borrower. Financial institutions may prepare excise tax returns to the department reporting income in periods which correspond to accounting methods employed by each institution for its normal accounting purposes in reporting to its supervisory authority.

Rule 146. Taxpayer takes the position that the FDIC Payments are not actual receipts subject to the B&O tax, but are merely accounting entries that do not actually reflect consideration received or accrued. In support of this proposition, the taxpayer cites *Weyerhaeuser v. Dept. of Revenue*, 106 Wn.2d 557, 723 P.2d 1141 (1986) and several published determinations of the Department of Revenue (Det. No. 91-319, 11 WTD 511 (1991); Det. No. 92-392, 12 WTD 535 (1992) *overruled on other grounds* by Det. No. 98-218, 18 WTD 46 (1999); Det. No. 86-309A, 4 WTD 341 (1986); and Det. No. 92-345, 12 WTD 501 (1992)).

In *Weyerhaeuser*, the Court held that the Department of Revenue could not segregate a portion of the purchase price of timber and tax and characterize that segregated portion as “interest,” when the contract for the purchase of timber did not provide for interest. *Weyerhaeuser*, 106 Wn.2d at 555-56. In this case, the Department has not changed the characterization of the FDIC Payments received by Taxpayer. Persons engaged in the business of providing financial and banking services are taxable under the “service and other activities” classification of the B&O tax. See RCW 82.04.290(2)(a); Rule 146. Similarly, Det. No. 91-319, 11 WTD 511 (1992) and Det. No. 86-309A, 4 WTD 341 (1987) both address transfers between affiliated entities created solely for recordkeeping purposes where no actual payments between entities were ever made. These cases are inapplicable here, because the FDIC and Taxpayer are not affiliated entities, and FDIC made actual payments to the Taxpayer. In this case, Taxpayer received the FDIC Payments as a direct result of engaging in the business of providing financial and banking services. The payments are therefore subject to B&O tax under the “service & other activities” classification.

Det. No. 92-345, 12 WTD 501 (1992) deals with accounting adjustments pursuant to the merger reorganization of two banks under federal statutes 26 U.S.C. § 368(a)(3)(D) and 26 U.S.C. § 368(a)(1)(G). In that determination, the Department concluded that the merger transaction was not a taxable sale, because the taxpayer did not “purchase” the merged bank. See 12 WTD 501. As no sale of assets technically occurred in that case, the true historical cost of the assets of the merged bank, and not the substituted basis required by GAAP for assets acquired in a merger, was the proper measure for calculating gain or loss for Washington excise tax purposes when the assets were eventually sold. *Id.* There was no merger reorganization in this case. Here, there was a purchase of certain Defunct Bank assets by Taxpayer, together with the assumption of certain Defunct Bank liabilities by Taxpayer, with a right of reimbursement on certain losses by the FDIC. The FDIC Payments are not income from the sales of the Defunct Banks’ assets. Therefore, the reasoning in 12 WTD 501 is inapplicable to the proper taxation of the FDIC Payments.

Det. No. 92-392, 12 WTD 535 (1992), *overruled on other grounds* by Det. No. 98-218, 18 WTD 46 (1999), has to do with the sale of part of a residential mortgage. For accounting purposes, the taxpayer recorded the estimated value of the portion of the loan it retained, which was the amount the taxpayer anticipated receiving on the loan going forward. 12 WTD at 538. In 12 WTD 535, the Department held that the taxpayer would owe B&O tax on the proceeds of the loan only when those proceeds were actually received, and not when their value was estimated for accounting purposes. *Id.* at 548. In this case, the FDIC Payments were actually received by the Taxpayer and B&O tax is properly due on the payments when received.

## **B. The FDIC Payments Are Not A “Return of Principal.”**

Taxpayer next argues that the FDIC Payments do not constitute “consideration,” because they represent a return of principal on amounts originally loaned to borrowers by the Defunct Banks. In making this argument, the Taxpayer cites *Kennewick v. State*, 67 Wn.2d 589, 409 P.2d 138 (1965), in which Justice Ott states that “return of principal has never heretofore been regarded as income for tax purposes.” *Kennewick*, 67 Wn.2d at 597 (Ott. J., concurring in part and dissenting in part). The majority, in *Kennewick*, however, found the receipts at issue were for the privilege of engaging in the activity of a water utility business. In this case, the FDIC Payments are

likewise received by Taxpayer for the privilege of engaging in the business of a financial institution.

The FDIC Payments are not a return of principal for a very simple reason. The “return of principal” on the loans that Taxpayer acquired from the Defunct Banks is the obligation of the actual borrowers, not the FDIC. *See, e.g.*, 12 WTD at 542. The return of principal remains the obligation of the borrower on each loan included in the loan portfolio of the Defunct Banks acquired by Taxpayer. The FDIC Payments do not decrease the obligation of the borrowers, but provides additional consideration to Taxpayer by the FDIC in the event of loan defaults, to induce Taxpayer into purchasing the Defunct Banks’ pool of underperforming loans.

While Taxpayer acknowledges that the FDIC Payments are paid by the FDIC and not the borrowers, Taxpayer argues that this fact should be disregarded because the FDIC Payments put the Taxpayer “back in the same economic position” as if the borrowers repaid the principal on the loans. We disagree with this characterization.

First, the Shared-Loss Payments have no effect on the borrowers’ obligations. The borrowers are still required to make their mortgage payments. Second, the borrowers’ liability for the loan amounts are unaffected by the Shared-Loss Payment Agreements. Third, the property of the borrowers that secures the principal still remains at risk. Fourth, Taxpayer still retains the right to the principal amount owed by the borrowers, separate and apart from Taxpayer’s right to the FDIC Payments. Fifth, Taxpayer retains the right to interest due on the loans. Sixth, Taxpayer retains its lien rights in the property securing the acquired loans. Finally, and most importantly, the FDIC Payments were bargained-for by the Taxpayer as an inducement to purchase the assets and liabilities and take over the operations of the Defunct Banks. The FDIC Payments are therefore not the return of principal on loans, but a separate income stream that Taxpayer is entitled to receive for the privilege of engaging in the business of a financial institution in Washington.

**C. The FDIC Payments Are Not Gains Realized from the Sale of Securities And Are Therefore Not Entitled to A Deduction for the “Cost” of Securities.**

Next, Taxpayer argues that the FDIC Payments should not be considered “gross income of the business,” because the Shared-Loss Agreement can be accounted for as a “derivative instrument,” namely a “notional principal contract.” Taxpayer takes the position that the Shared-Loss Agreement is effectively a derivative instrument used in a hedging activity. Taxpayer concludes that the Loan Share Agreement should therefore be taxed in accordance with the Department’s position on taxation of other hedging activities.

RCW 82.04.080 defines “gross income of the business” as including “gains realized from trading in stocks, bonds, or other evidences of indebtedness.” RCW 82.04.080(1). Taxpayer acknowledges that Rule 146, which uses the same definition of “gross income of the business” as RCW 82.04.080(1), governs the taxation of financial institutions. Despite that acknowledgement, Taxpayer argues that the Department should instead apply the WAC 458-20-162 (Rule 162) definition of “gross income from trading” to the FDIC Payments, because they are effectively similar to certain derivative instruments used for investment hedging. Taxpayer argues that, if



the Shared-Loss Agreements are indeed a hedging activity, the FDIC Payments should be netted against the corresponding loan portfolio principal loss that triggered the payments.

Taxpayer cites two of the Department's determinations, Det. No. 90-113, 9 WTD 276-1 (1990) and Det. No. 80-445, 9 WTD 181 (1989), for the proposition that Rule 162 applies to financial institutions engaged in the same activities as stockbrokers or security houses, when the financial institutions are engaged in "the business of trading in securities." *See e.g.*, 9 WTD 276-1; 9 WTD 181. Financial institutions engaged in "the business of trading in securities" are taxable on their "gross income from trading" in those securities. Rule 162(4). Rule 162 defines "gross income from trading" as follows: "the amount received from the sale of stocks, bonds and other securities over and above the cost or purchase price of such stocks, bonds and other securities." Rule 162(4).

The problem with Taxpayer's reasoning is that the FDIC Payments are not an "amount received from the sale of stocks, bonds, or other securities" under Rule 162(4). Taxpayer's right to the FDIC Payments are not triggered by any "sale." They are instead triggered by Taxpayer's losses on acquired loans reaching certain thresholds. Taxpayer does not receive the FDIC Payments as a result of a "sale" of stocks, bonds, securities, or anything else. Because Taxpayer does not receive the FDIC Payments as the result of a sale, they cannot be characterized as "gains realized from trading in stocks, bonds, or other evidences of indebtedness" or "gross income from trading." RCW 82.04.080 and Rule 162(4). Because the FDIC Payments are not "gross income from trading," Taxpayer cannot deduct the "cost or purchase price" of "stocks, bonds, or other securities," from the FDIC Payments it received. Rule 162(4). We hold that the FDIC Payments were not income realized from "trading in stocks, bonds, or other evidences of indebtedness," and, therefore, the B&O tax on the FDIC Payments should not be limited to "gains." *See, e.g.*, RCW 82.04.080. The entire gross proceeds of the FDIC Payments are taxable. *See id.*

#### **D. The FDIC Payments Are Not Insurance Proceeds.**

Taxpayer's final argument why FDIC Payments are not "gross income of the business" is that the FDIC Payments are analogous to insurance proceeds and are therefore not subject to B&O tax. In support of this proposition, Taxpayer relies on Det. No. 98-035, 17 WTD 174 (1998), and the Board of Tax Appeals review of that Determination, *Rebitzer v. Dep't of Revenue*, BTA Docket No. 52716 (May 3, 1999). 17 WTD 154 dealt with the issue of payments from an employer funded union trust fund that reimbursed union employers for higher labor costs in order to compete with employers of non-union labor. *See* 17 WTD 154. Neither that determination nor the subsequent BTA decision held that those reimbursements were exempt from B&O tax because they were similar to insurance proceeds.

... 17 WTD at 177. In 17 WTD 174, the taxpayer was entitled to the union subsidies, because it was engaged in a business employing unionized workers. In this case, Taxpayer was entitled to the FDIC Payments, because it was engaged in the banking business, and was therefore in a position to acquire and operate the Defunct Banks.

Taxpayer attempts to distinguish the FDIC Payments from the union trust funds in 17 WTD 174 by characterizing them as "true surety payments" from the FDIC to guarantee against an unusual

risk of loss not involved in the ordinary course of Taxpayer's business. However, Taxpayer does not cite any statute or rule that would support an interpretation that the FDIC Payments were indeed insurance proceeds. Taxpayer does cite WAC 458-20-257 (Rule 257), which addresses the taxability of insurance proceeds and reads, in relevant part, as follows:

In the event a warrantor purchases an insurance policy to cover the warranty, amounts received by the warrantor under the insurance policy are insurance claim reimbursements not subject to B&O tax.

Rule 257(2)(e) (1990).<sup>4</sup>

In this case, however, Taxpayer never purchased an insurance policy. The Shared-Loss Agreements with the FDIC are not insurance policies. Because the FDIC Payments are not paid to Taxpayer as a result of an insurance policy, they are not insurance proceeds. Even if the Department had the authority to treat payments that were "analogous to insurance proceeds" as insurance proceeds, and we are unaware of any such authority, we do not agree that the FDIC Payments are analogous to insurance proceeds. The FDIC Payments are a specified inducement, offered by the FDIC in return for Taxpayer's agreement to purchase certain assets and liabilities of the Defunct Banks from the FDIC and take over the operation of the Defunct Banks on a going-forward basis.

Taxpayer has cited no statute, rule, or other authority that exempts these amounts from B&O taxation. The B&O tax is "extensive and is intended to impose . . . tax upon virtually all business activities carried on in the State." *Analytical Methods, Inc. v. Dep't of Revenue*, 84 Wn. App. 236, 241, 928 P.2d 1123, 1125 (1996). In determining whether Taxpayer is entitled to an exemption or deduction for the FDIC Payments, we must narrowly construe the exemption and deduction statutes. *Id.* We hold that there is no exemption or deduction for FDIC Shared-Loss Payments in Washington's tax code. Therefore, the FDIC Payments are properly included in Taxpayer's gross receipts for purposes of Washington's B&O tax.

### **III. The FDIC Payments Related to Bank I and Bank II Were Properly Apportioned to Washington.**

As a final matter, Taxpayer contests the Audit Division's assignment of the FDIC Payments Taxpayer received pursuant to the Bank I and Bank II Shared-Loss Agreements as Washington income for apportionment purposes.

#### **A. FDIC Payments Received Before June 1, 2010.**

Before June 1, 2010, WAC 458-20-14601 (Rule 14601) was the applicable rule instructing how income was to be apportioned for financial institutions doing business both inside and outside of Washington.<sup>5</sup> The issue here is not whether the FDIC Payments were taxable, but whether the FDIC Payments that Taxpayer received pursuant to the Shared-Loss Agreements were properly

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<sup>4</sup> Rule 257 was amended and replaced effective May 3, 2015.

<sup>5</sup> Rule 14601 provided tax reporting instructions for financial institutions doing business both inside and outside of Washington for periods prior to June 1, 2010.

apportioned. Under Rule 14601, the Audit Division assigned all of the FDIC Payments received by Taxpayer from the Shared-Loss Agreements relating to Banks I and II to Washington for purposes of determining the receipts factor. *See* Rule 14601(4). Correspondingly, the Audit Division assigned the FDIC Payments received by Taxpayer pursuant to the terms of the Shared-Loss Agreements relating to Bank III outside of Washington. *Id.*

Taxpayer claims that the Shared-Loss Agreements are “investment assets” under Rule 14601(4)(m) and that the resulting FDIC Payments constitute income properly assigned to its corporate headquarters in [out of state] Rule 14601 defines “investment assets,” in relevant part, as follows:

**(m) Receipts from investment assets and activities and trading assets and activities.**

(i) Interest, dividends, net gains (but not less than zero) and other income from investment assets and activities and from trading assets and activities are included in the receipts factor. Investment assets and activities and trading assets and activities include but are not limited to: Investment securities; trading account assets; federal funds; securities purchased and sold under agreements to resell or repurchase; options; futures contracts; forward contracts; notional principal contracts such as swaps; equities; and foreign currency transactions. With respect to the investment and trading assets and activities described in (m)(i)(A) and (B) of this subsection, the receipts factor includes the following:

(A) The receipts factor includes the amount by which interest from federal funds sold and securities purchased under resale agreements exceeds interest expense on federal funds purchased and securities sold under repurchase agreements.

(B) The receipts factor includes the amount by which interest, dividends, gains and other receipts from trading assets and activities, including but not limited to assets and activities in the matched book, in the arbitrage book, and foreign currency transactions, exceed amounts paid in lieu of interest, amounts paid in lieu of dividends, and losses from such assets and activities.

(ii) The numerator of the receipts factor includes interest, dividends, net gains (but not less than zero) and other receipts from investment assets and activities and from trading assets and activities described in (m)(i) of this subsection that are attributable to this state.

Rule 14601(4)(m)<sup>6</sup> (emphasis added). Having asserted that the Shared-Loss Agreements are “investment assets,” Taxpayer then argues that the FDIC Payment income resulting from those Shared-Loss Agreements should be assigned to . . . . With respect to the proper assignment of investment assets, Rule 14601 reads in relevant part, as follows:

<sup>6</sup> The language in WAC 458-20-19404(4)(k), defining “investment assets” for periods after June 1, 2010 is not materially different than the language in Rule 14601(4)(m).

(v) The taxpayer has the burden of proving that an investment asset or activity or trading asset or activity was properly assigned to a regular place of business outside of this state by demonstrating that the day-to-day decisions regarding the asset or activity occurred at a regular place of business outside this state. If the day-to-day decisions regarding an investment asset or activity or trading asset or activity occur at more than one regular place of business and one such regular place of business is in this state and one such regular place of business is outside this state, such asset or activity is considered to be located at the regular place of business of the taxpayer where the investment or trading policies or guidelines with respect to the asset or activity are established. Such policies and guidelines are presumed, subject to rebuttal by preponderance of the evidence, to be established at the commercial domicile of the taxpayer.

Rule 14601(4)(v).<sup>7</sup>

We first address the question whether the Shared-Loss Agreements were “investment assets” under Rule 14601(4)(m). Taxpayer argues that the Shared-Loss Agreements are effectively “notional principal contracts” or some other derivative instrument, because they can be used for hedging purposes. We disagree with this characterization.

In Section **II.C.** of this determination, *supra*, we discussed why the FDIC Payments were not “gross income from trading,” because the income did not originate from the “sale” of a security. Now, we further hold that the Shared-Loss Agreements themselves are not “investment assets.”

Rule 14601(4)(m) lists examples of “investment assets and activities” and “trading assets and activities.” While those terms are not limited to the examples listed in the rule, we do not find that the Shared-Loss Agreements in this case are comparable to any of the listed examples of investment assets. Under the doctrine of *noscitur a sociis*, “the meaning of words may be indicated or controlled by those with which they are associated.” *State v. Jackson*, 137 Wn.2d 712, 729, 976 P.2d 1229 (1999) (quoting *Ball v. Stokely Foods, Inc.*, 37 Wn.2d 79, 87-88, 221 P.2d 832 (1950); *Shurgard Mini-Storage v. Dep’t of Revenue*, 40 Wn. App. 721, 727, 700 P.2d 1176 (1985)). In applying this doctrine to determine the meaning of a word in a series, “[i]t is. . . familiar policy in the construction of terms of a statute to take into consideration the meaning naturally attaching to them from the context, and to adopt the sense of the words which best harmonizes with the context.” *Jackson*, 137 Wn.2d at 729, 976 P.2d at 1237.

The examples of “investment assets and activities” in Rule 14601(4)(m) includes examples of investments that are commonly bought, sold, or traded by financial institutions. The examples include investment assets that are purchased by investors for the prospect of gain and are traded on secondary markets. The Shared-Loss Agreements in this case are not like any of the listed investment asset examples. The Shared-Loss Agreements are two-party contracts, between the FDIC and Taxpayer, that govern when Taxpayer is entitled to reimbursement by the FDIC on losses it suffers from operating Defunct Banks it purchased out of receivership; they are not in

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<sup>7</sup> The language in WAC 458-20-19404(4)(v), addressing the proper assignment of “investment assets” received after June 1, 2010, is not materially different from the language in Rule 14601(4)(v).

the nature of investment assets.<sup>8</sup> As such, they are unlike the examples of “investment assets” listed in Rule 14601(4)(m).

Pursuant to the contract terms of the Shared-Loss Agreements, the FDIC Payments arise from Taxpayer’s continuing operation of the Defunct Banks it purchased from the FDIC. For that reason, we hold that, for purposes of apportioning Taxpayer’s income for periods prior to June 1, 2010, the FDIC Payments should be assigned to the location where Taxpayer services the loans of the Defunct Banks that give rise to the FDIC Payments when the loss provisions were triggered. *See* Rule 14601(4)(l). For purposes of calculating the receipts factor under Rule 14601, the Audit Division assigned the FDIC Payments received under the Shared-Loss Agreements for Defunct Banks I and II to Washington, because all the branches of Banks I and II are located in Washington. The Audit Division assigned the FDIC Payments received under the Shared-Loss Agreements for Defunct Bank III outside of Washington. We hold that the Audit Division’s apportionment methodology is in accord with Rule 14601. The Audit Division’s apportionment methodology is affirmed.

#### **B. FDIC Payments Received After June 1, 2010.**

For periods after June 1, 2010, WAC 458-20-19404 (Rule 19404) instructs how income is to be apportioned for financial institutions doing business both inside and outside of Washington. Again, the issue here is not whether the FDIC Payments are taxable, but whether the FDIC Payments that Taxpayer received pursuant to the Shared-Loss Agreements for the Washington banks, Bank I and Bank II, were properly apportioned.

Taxpayer’s arguments under Rule 19404 are materially no different than its arguments under Rule 14601 and the applicable rule language is also not materially different. For the reasons stated in Section **III.A.**, *supra*, we likewise hold that the Shared-Loss Agreements are not “investment assets” as defined by Rule 19404(4)(k). We therefore affirm the Audit Division’s apportionment methodology under Rule 19404, wherein the Audit Division assigned the FDIC Payments for Banks I and II to Washington and the FDIC Payments for Bank III outside of Washington.

#### **DECISION AND DISPOSITION**

Taxpayer’s petition is denied.

Dated this 16th day of October, 2014.

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<sup>8</sup> Having found that the Shared-Loss Agreements are not “investment assets,” we are not required to determine whether Taxpayer has met its burden of showing that the FDIC Payment income should be assigned to . . . instead of the location of the Defunct Bank branches under Rule 14601(4)(v).