Cite as Det. No. 01-168E, 22 WTD 228 (2003)

BEFORE THE APPEALS DIVISION
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. 01-168E
. . .	)	Registration No. . . .
	)	Doc. No. FY . . . /Audit No. . . . Doc. No. FY . . . /Audit No. . . . And Notices of Balance Due Nos. . . . Both of which have been assumed by Doc. No. . . . / Audit No. . . . Docket No. . . .

[1] RULE 194; RCW 82.04.460: B&O TAX – APPORTIONMENT – BORROWING OF FUNDS -- DEFERRED INSTALLMENT SALES BY RETAILER. When a retailer did not lend money, but sold its products on a deferred installment basis to its credit card customers, the retailer's costs of borrowed funds used to replace inventory constituted an expense of its retailing activity, and cannot be used in calculating cost apportion of its credit card finance charge income.

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.

DIRECTOR'S DESIGNEE: Susan Y. Price

NATURE OF ACTION:

Taxpayer protests the Department of Revenue's (Department's) refusal to apply the apportionment methodology of Det. No. 89-459A, 11 WTD 17 (1991) in apportioning its credit activity income.[1]

FACTS:

Bauer, A.L.J. -- Taxpayer is a retailer with stores throughout the United States. For the purposes of Washington B&O and retail sales taxes in this audit, the Taxpayer pays retailing B&O tax on its gross sales in Washington and correctly remits retail sales tax charged on those sales.

In conjunction with its retailing activity, Taxpayer issued its own credit card to customers. Customers with Taxpayer's credit card were able to make deferred payments on merchandise they purchased from any of Taxpayer's stores. In addition to reporting retailing B&O tax on its retail sales, Taxpayer paid service B&O tax on the finance charges[2] that accrued on Washington customers' credit card purchases.

Historically, Taxpayer reported finance charge income[3] based upon what the Department's Audit Division (Audit) describes as a "separate accounting" method.[4] Using this accounting method, Taxpayer reported to Washington State only those finance charges it estimated it received from Washington customers, most of whose accounts were directly serviced by Taxpayer's Washington credit centers. Taxpayer estimated and reported the same monthly finance charge amount for the months January 1987 through September 1989, which amounts Audit ultimately found to be substantially under-reported.

On March 25, 1994 Taxpayer enclosed a "claim for refund" for the period December 1986 through January 1994[5] with its February 1994 excise tax return. Taxpayer stated it had over-reported its gross receipts, and thus overpaid tax, on the finance charges it received on credit card purchases, and additionally stated:

> This is to inform you that [Taxpayer] will now begin apportioning consumer interest income earned from the use of credit cards (revolving charge accounts) on the basis of the "cost of

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

[2] Even though Taxpayer refers to its credit card income as "interest," the term "finance charge" was used on its credit card billings. We will therefore refer to this income as "finance charges."

[3] Otherwise referred to as "interest income."

[4] Taxpayer objects to Audit's characterization of this method. Taxpayer characterizes the method used as "tantamount to employing a single factor sales factor – a factor that is not supported by the Washington Apportionment Statutes." Taxpayer's letter to the Assistant Director, Appeals, dated May 6, 2001.

[5] Taxpayer was notified of this partial audit in May 6, 1991. Fieldwork began on March 2, 1992. Taxpayer signed an initial waiver of the statute of limitations on May 22, 1991 (waiving statute of limitations for 1987 through 1992). Taxpayer signed additional waivers of the statute of limitations on September 1, 1992; November 19, 1993; and October 19, 1994. The period from January 1, 1987 was therefore open to refund requests in accordance with RCW 82.32.060 when Taxpayer's refund request was made.

> doing business" apportionment method per RCW 82.04.460 and WAC 458-20-194(10) [sic]. See also, Determination No. 89-459, 8 WTD 227 (1989), and Final Determination No. 89-459A, 11 WTD 17 (1991).

Instead of waiting for a refund, however, Taxpayer took its "refund" as "credits" or unauthorized deductions[6] from both its February 1994 and March 1994 excise tax returns. The Department, in the course of conducting a partial audit of Taxpayer's records, denied Taxpayer's request for "refund" by letter dated December 14, 1995. Consequently, the Department issued balances due in the amounts of $ . . . and $ . . . , for February and March 1994, respectively.[7] In denying the refund claim, the Audit Division wrote Taxpayer and explained:

> The partial audits apportion the finance charge and servicing income to Washington using the cost of doing business method, as requested. However, we cannot agree to follow Determination 89-459A, 11 WTD 17, as this determination is obviously directed at banks and other financial institutions, and . . . is not a financial institution.

Audit contended that Det. No. 89-459A,[8] supra, which allowed the out-of-state sourcing of borrowing (i.e., interest) costs, was applicable only to financial institutions that borrowed in order to further lend their funds. Although Taxpayer earned finance charges on the deferred payments it received on the sales of its goods, Audit declared that Taxpayer was not a financial institution because it merely sold its goods on time, receiving deferred payments. In support of its position, Audit cited ETB 901, 2 ETB 467, issued Nov 15, 1994, which states:

> (2)(c) New financial services B&O tax. There is a new B&O tax classification which applies to persons engaged in banking, loan, security, investment management, investment advisory, or other financial businesses. These services had previously been taxable under the service and other business activities tax classification. This tax classification applies to all income derived from the listed activities, including investment and interest income. <u>However, interest income received by persons selling tangible personal property continues to be taxable under the service B&O tax classification since such sellers are not considered to be in a financial business by reason of making installment sales. See RCW 82.04.290.</u>

(Emphasis added.)

As a result of not applying Det. No. 89-459A, the Department's Audit Division (Audit) did not permit Taxpayer to source its borrowing costs to [State A], where Taxpayer's borrowing occurred, in order to apply Washington's cost apportionment formula to Taxpayer's business activity of generating credit card finance charges. This was so even though, according to Taxpayer, Audit

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[6] I.e., "self-help" refunds.

[7] The Department issued tax assessment (Document No. . . .) on March 23, 2001 covering the period January 1, 1993 through December 31, 1997. This tax assessment, which remains due, also contained the balances due for February and March 1994.

[8] Det. No. 89-459A has since been overruled by Det. No. 01-006, 20 WTD 124 (2001).

conceded that a certain identifiable percentage of its [State A] borrowing activity was attributable to Taxpayer's allowing deferred payments on its customers' credit card sales.

The Department has now completed the partial audit of taxpayer's records and has identified the amounts Taxpayer actually received in finance charges and servicing fees from its credit card customers for the audit periods from January 1, 1987 to December 31, 1991 and from January 1, 1992 to December 31, 1993. As a result, in addition to the Document No. . . . still outstanding, Document No. FY . . . was issued on December 20, 1995 showing tax and interest due in the amount of $ . . . , and FY . . . was issued on the same date showing a credit in the amount of $ . . . . The credit was applied to Document No. FY . . . , resulting in a net amount due as of December 31, 1995 of $ . . . . Although the outstanding tax assessment Document No. . . . is not in its entirety at issue in this appeal, the balance due notices for February and March 1994 were assumed in that assessment and are at issue. The total amount here at issue is therefore $ . . . , plus any outstanding interest.

This case, which has been designated as executive level, is technically still before Audit, but has been brought before this Division, by agreement between Taxpayer and the Department, for resolution of the issues concerning the apportionment of Taxpayer's finance charge income.

ISSUES:

The following issues have been raised in this case:

> 1. Was Taxpayer's cost of borrowing funds attributable to its business of earning finance charge income through the extension of credit to its credit card customers?
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> 2. To determine the amount of its taxable finance charge income from its sales, is the apportionment method of Det. No. 89-459A, supra, available to a national retailer which extends credit to its customers by use of its own credit cards?
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> 3. For apportionment purposes, does RCW 82.04.460(2) require the Department to treat those who sell goods by way of deferred payments the same as it treats financial institutions that earn finance charges by making loans?

DISCUSSION:

Under certain circumstances, for purposes of determining the measure of the tax, taxpayers performing services both within and without the state may apportion their gross income between the states in which they conducted business activity. In this regard, the first two subsections of RCW 82.04.460 provide for apportionment:

> (1) Any person rendering services taxable under RCW 82.04.290 and maintaining places of business[9] both within and without this state which contribute to the rendition of such services shall, for the purpose of computing tax liability under RCW 82.04.290, apportion to this state that portion of his gross income which is derived from services rendered within this state. Where such apportionment cannot be accurately made by separate accounting methods, the taxpayer shall apportion to this state that proportion of his total income which the cost of doing business within the state bears to the total cost of doing business both within and without the state.
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> (2) Notwithstanding the provision of subsection (1) of this section, persons doing business both within and without the state who receive gross income from service charges, as defined in RCW 63.14.010 (relating to amounts charged for granting the right or privilege to make deferred or installment payments) or who receive gross income from engaging in business as financial institutions within the scope of chapter 82.14A RCW (relating to city taxes on financial institutions) shall apportion or allocate gross income taxable under RCW 82.04.290 to this state pursuant to rules promulgated by the department consistent with uniform rules for apportionment or allocation developed by the states.

RCW 82.04.460(1) sets forth two distinct methods of apportionment. The statutorily preferred method of apportionment under RCW 82.04.460(1) is separate accounting.[10] However, if apportionment by the use of separate accounting cannot be accurately made, then cost apportionment[11] shall be used. Both separate accounting and cost apportionment attempt to accurately determine the measure of the B&O tax on a taxpayer's business activities in Washington. Det. No. 01-006, 20 WTD 124 (2001). The taxpayer and the Audit Division agree that separate accounting is not available to the taxpayer for calculation of its credit card finance charge income. Therefore, the taxpayer must use cost apportionment to determine the gross income subject to Washington's B&O tax.

Cost apportionment is the formulary apportionment method used by Washington. Cost apportionment focuses on <u>costs</u> and uses a formula based on those costs to determine the gross income from Washington activities. Cost apportionment focuses on <u>costs</u> unlike separate accounting (geographic allocation of income), which focuses on <u>income</u>. Because these two methods are based on entirely different factors, separate accounting concepts/principles are not applicable to cost apportionment.

RCW 82.04.460(1) states: ". . . the taxpayer shall apportion to this state that portion of his <u>total income</u> which the <u>cost of doing business within the state</u> bears to the <u>total cost of doing business</u>

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[9] For the purposes of RCW 82.04.460(1), a place of business does not mean a physical location. Rather, if a taxpayer conducts activities in a state sufficient to create nexus under Washington standards, then the taxpayer is deemed to have a "place of business" in that state for apportionment purposes. Det. No. 01-006, 20 WTD 124 (2001), OVERRULING: Det. No. 86-297, 2 WTD 23 (1986); Det No. 92-117, 12 WTD 147 (1993).

[10] Separate accounting is an apportionment method sometimes referred to as geographic or transactional accounting. <u>See Container Corp. v. Franchise Tax Bd.</u>, 463 U.S. 159, 164 (1983).

[11] Also called formulary apportionment.

both within and without the state." (Emphasis added.) To apportion the tax correctly, this statute requires three calculations to determine the measure of the Washington B&O tax. First, one must determine what income is subject to apportionment. Second, one must determine the total cost of doing business related to that income. Third, one must determine the cost of doing business in Washington related to that income.

The first step – determining that Taxpayer's credit card finance charge income is subject to apportionment – has been completed and is not at issue. The second step – determining the costs of doing business related to Taxpayer's credit card finance charge income – is at issue. Namely, was the interest ("borrowing costs") Taxpayer paid on out-of-state loans a cost of generating its credit card finance charge income, when the borrowed funds were used to keep its business operating.

Taxpayer argues that its cost of borrowing was a legitimate expense of its credit activities, and not its retailing activities. This is because, argues Taxpayer, there was a cause and effect relationship between its borrowing costs and the financing revenues. Taxpayer reasons as follows:

> . . . We begin with an assumption that even if [Taxpayer] were selling exclusively on a cash basis, [Taxpayer] would nonetheless borrow money from time to time to cover variances in its cash flow and to make timely seasonal inventory purchases, etc. Call such borrowing "Quantum A borrowing."
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> Now make a second assumption that is compelled by the facts of this case. Assume that [Taxpayer] decides to offer its customers the service of extending credit. A necessary consequence of that service is that [Taxpayer] will not receive cash for purchases at the point of sale to the extent that customers elect to defer payment by purchasing on credit. The extension of credit will necessarily delay receipt of cash. It follows as night follows day that cash which is not received from customers at the point of sale must be obtained from another source. So [Taxpayer] necessarily borrows more than its "Quantum A borrowing." Call that "Quantum B borrowing."
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> To say that [Taxpayer's] "Quantum B" borrowing costs were "not in support of its activity of extending credit" . . . is to ignore the cause and effect relationship between the extending of the credit and the need to borrow beyond what would be needed if cash were received on all sales at the point of sale.

(Taxpayer's letter to the Assistant Director, Appeals, dated May 6, 2001, pp. 4-5.)

Taxpayer takes the position that, to say that Taxpayer's "Quantum B" borrowing costs were anything except in support of its activity of extending credit, ignores the cause and effect relationship between the extending of credit and the need to borrow beyond what would be needed if cash were received on all sales at the point of sale.

Taxpayer cites, in legal support of the proposition that its borrowing costs should be considered a cost of its credit business the following statement in Rena-Ware Distributors, Inc. v. State, 77 Wn.2d 514, 463 P.2d 622 (1970):

> We are of the opinion that the Department of Revenue has correctly construed RCW 82.04.290, which levies a tax on "every person engaging within this state in any business activity . . . [including] the business of rendering any type of service which does not constitute a 'sale at retail'. . . ." The business activity of servicing installment accounts falls naturally within this definition, and it is our conclusion that the legislature intended that this activity should be taxed under this section rather than under RCW 82.04.250, taxing retail sales.

(Rena-Ware, supra at 517.) Taxpayer also relies on the following language in Department of Rev. v. J.C. Penney Co., 96 Wn.2d 38, 633 P.2d 870 (1981) in support of its proposition that it should be permitted to apportion its credit card finance charge income using its out-of-state borrowing expense:[12]

> Thus, a single question is posed: Which activities of Penney's give rise to the finance charge? Our answer is that all of Penney's activities relating to the sale for credit give rise to the finance charge.

(J.C. Penney, supra at 42, Taxpayer's emphasis.)

Taxpayer also refers us to Pacific First Federal Savings and Loan Association v. Washington, 92 Wn.2d 402, 598 P.2d 387 (1979), a case involving the investment of reserve funds in which one person, located in Washington, accomplished this activity on the taxpayer's behalf in about one hour per day. Washington customers supplied fifty percent of the funds, and Oregon customers supplied the other fifty- percent. According to Taxpayer, that court looked to the source of the funds and held that the taxpayer was entitled to apportion fifty percent of its income to Oregon.[13] Taxpayer likens such reasoning to that in Final Det. No. 89-459A.

Taxpayer claims that retail businesses such as it borrow billions of dollars every year, and that that kind of commercial activity requires comprehensive and sophisticated (as well as expensive) governmental services and protections from government. For example, the legal environment that must be created to permit the raising of billions of equity and debt dollars requires, at its base, a comprehensive set of banking laws and laws governing the raising of money from the public. Such laws cover not only the raising of the capital, but also its repayment. Such laws are, in turn,

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[12] Only gross income taxed under RCW 82.04.290 may be apportioned under the Washington Revenue Act. Det. No. 01-006, supra. RCW 82.04.290 has been amended several times. Effective July 1, 1993, RCW 82.04.290 was amended to add "selected business services," "financial business" and "international investment management services" to the already-existing "service and other activities" B&O tax classification. Interest income not taxed under RCW 82.04.290(2) (i.e., "financial business" income) was taxed at the somewhat higher "service and other activities" classification of RCW 82.04.290(4).

[13] Although not dispositive, we disagree with Taxpayer's characterization of the holding in this case.

implemented by regulations promulgated by regulating agencies in both the fields of equity and debt capital. These agencies not only promulgate the regulations, but also enforce them, requiring a court system capable of dealing with the issues involved.

Despite Taxpayer's arguments, however, we believe the facts in this case require a finding that Taxpayer's borrowing costs were in direct support of its retailing activity, and not in support of its activity of extending credit. Taxpayer was and is a retail seller of goods and other services[14] correctly taxable under the retailing classification of RCW 82.04.250(1).[15] Under this B&O tax classification, a taxpayer's "gross proceeds of sale" are taxed without deduction for business expenses, such expenses including "interest." RCW 82.04.070.[16]

Taxpayer did not borrow funds in order to loan or advance money to its credit card holders. Taxpayer borrowed funds in order to purchase inventory and otherwise support its retailing activity.

Because the credit cards used by Taxpayer's customers were Taxpayer's own cards, customers using their cards were merely paying for their merchandise and services on an installment basis.[17] Unlike more conventional credit cards that pay third party providers on a cardholder's behalf,[18] Taxpayer did not advance – or lend—funds to its customers to pay for their purchases. Instead of engaging in a lending activity, Taxpayer earned finance charge income from the acceptance of deferred or installment payments on its own sales of inventory and services. Washington tribunals have spoken to the issue of selling on a deferred or installment basis. These rulings have a similar theme: that the acceptance of deferred payments is not the same as the lending or investment of money. See Detlefsen v. Department of Rev., B.T.A. Docket No. 84-38 (1985), quoting Clifford v. State, 78 Wn.2d 4, 8, 469 P.2d 549 (1970):

> The particular business activity of the appellants which is taxed is that of permitting deferred payment for the sale of real estate which it sells . . . . Making a loan and taking a land contract as security is not the same activity as selling a piece of land and accepting the payment in installments. In one activity, money is advanced. In the other, no money is advanced by the seller; rather he relinquishes the right to immediate payment. This is a sufficient distinction and fact to justify the difference in tax treatment. . . . [I]nterest income is a financing charge, it occurs by allowing payments to be made over an extended period of time and as a result, a fee or interest is realized; this does not meet the test of an investment.

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[14] Except for any services not considered retail sales under the Revenue Act.

[15] "Upon every person except persons taxable under RCW 82.04.260(5) or subsection (2) of this section engaging within this state in the business of making sales at retail, as to such persons, the amount of tax with respect to such business shall be equal to the gross proceeds of sales of the business, multiplied by the rate of 0.471 percent."

[16] "Gross proceeds of sales" means the value proceeding or accruing from the sale of tangible personal property and/or for services rendered, without any deduction on account of the cost of property sold, the cost of materials used, labor costs, interest, discount paid, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses."

[17] In September 1996, Taxpayer issued a notice to its credit card holders to the effect that its customer credit cards accounts were being transferred to an affiliated bank.

[18] Thereby making a loan to the cardholder.

(Emphasis added.) Rena-Ware, supra at 516-17, relied on by Taxpayer, held that service charges exacted for the privilege of buying on time (e.g., on an installment basis) are not part of the selling price of a product. Such service charges are, instead, a separate compensation for the seller's expenses in providing the services necessary to extend such credit. Because the activities relating to this service charge are not expressly set forth in chapter 82.04.RCW, they are reasonably included in the "services and other activities" catch-all provision of RCW 82.04.290.[19] The Department has never contended Taxpayer did not have two taxable activities – retailing and the extension of credit (this latter activity taxable under the service and other activities classification of the B&O tax).

J.C. Penney, also relied on by Taxpayer, stated that "all of Penney's activities relating to the sale for credit give rise to the finance charge" (emphasis ours). However, by "all of Penney's activities," the court was specifically referring to "all" of the activities enumerated – by stipulation of the parties -- to be at issue in that case. These activities consisted of Penney's out-of-state activities (i.e., "generally, those involving credit approval, billing, and bookkeeping"[20]) and Penney's instate activities (i.e., credit sales activities such as the selling of merchandise on credit, assisting customers with initial and denied credit applications, the receipt of payments and collection of delinquent Washington accounts[21]). The court held that all in-state activities promoting the sale on credit were sufficient to bring the finance charge income within Washington's taxing statute. Neither party contended borrowing necessitated by the extension of credit was an activity or expense supporting J.C. Penney's credit business. The J.C. Penney court, thus, never considered such borrowing.

Taxpayer has offered no support for its contention that the borrowing in which it engaged was in support of its credit, and not its retailing, activities. In fact, we take the Taxpayer's Quantum A/Quantum B argument (quoted above) to be an admission that the opposite is true. Taxpayer admits that the funds were borrowed in order to purchase inventory to be sold at retail. Taxpayer offers the Quantum A/Quantum B argument to contend these borrowing expenses should be considered "lending" expenses. This is because, according to Taxpayer, its practice of making deferred sales indirectly affected its ability to cover other day-to-day business expenses (such as the purchase of inventory), making borrowing activity necessary.

Taxpayer did not earn finance charge income because it loaned funds to its customers, but because it sold goods and services at retail and permitted its customers to pay for these over time on a deferred installment basis. Because Taxpayer borrowed funds in order to purchase inventory, Taxpayer's borrowing expense clearly constituted a cost of engaging in Taxpayer's business of retailing, an activity taxable under RCW 82.04.250(1), and not a cost of its business of earning finance charges on its installment sales, taxable under RCW 82.04.290(2). Taxpayer separates its borrowing costs into Quantum A/Quantum B in an attempt to transform one of its costs of acquiring goods for resale from a non-deductible cost of a retailing activity into an expense of a service activity. If it were considered to be an out-of-state expense of a service activity, it could be included in an apportionment formula to reduce the percentage of such service income taxable by the State of Washington.

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[19] supra, at 516-17
[20] J.C. Penney, supra, at 44.
[21] J.C. Penney, supra, at 44.

RCW 82.04.460(1) requires that apportionment apply only to business activities taxable under RCW 82.04.290. Because Taxpayer's borrowing cost was in support of its retailing activity taxable under RCW 82.04.250(1), this borrowing cost may not be properly used in any formula apportioning Taxpayer's credit card finance charge income. See Det. No. 01-006, 20 WTD 124 (2001)

Accordingly, Taxpayer's petition as to this issue is denied.

Taxpayer has strenuously advanced two additional arguments (i.e., the second and third issues)[22] attempting to justify the use of its borrowing expense to apportion its credit card finance charges income under the provisions of Final Det. No. 89-459A, which permitted such situsing of borrowing costs for financial businesses. Both of these additional arguments, however, assume that Taxpayer's interest expense was, in fact, an expense attributable to its business of extending credit. Because we have determined otherwise, these two arguments are moot, and we need not further address them.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 31st day of October, 2001.

[22] First, Taxpayer argues it should have been permitted to use its borrowing costs to apportion its credit card finance charge income in accordance with the provisions of Final Det. No. 89-459A, 11 WTD 17 (1991).
Second, Taxpayer argues that subsection (2) of RCW 82.04.460, which it characterizes as a "carve-out" of RCW 82.04.460(1), suggests the Department should have treated financial institutions and those who sell goods by way of deferred payments similarly under the general provisions of subsection (1) prior to the adoption of Rule 14601.