Cite as 11 WTD 21 (1989).

BEFORE THE INTERPRETATION AND APPEALS SECTION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition) D E T E R M I N A T I O N
For Correction of Assessment and)
For Refund of) No. 89-461
)
. . .) Registration No. . . .
) . . ./Audit No. . . .
)
)
and)
)
. . .) Registration No. . . .
) Tax Assessment Nos. . . .
) and . . .

[1] RCW 82.04.4292: BUSINESS AND OCCUPATION TAX -- DEDUCTIONS --INTEREST -- GAINS ON SALES OF FIRST MORTGAGE LOANS. The gain from the sale of a mortgage is not an "amount derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties."

[2] RULE 111: BUSINESS AND OCCUPATION TAX -- ADVANCES AND REIMBURSEMENTS -- LOAN APPLICATION REFUNDABLE DEPOSITS. Refundable deposits from loan applicants to cover the financial institution's costs in processing loan applications (costs for credit reports, title insurance, property appraisals, etc.) held not excludable under Rule 111 when no evidence offered to indicate that the outside consultants recognized that they were to be paid only from funds received from the taxpayer's clients, or that the taxpayer would not be liable to them for compensation if customer funds were not received. Christensen cited.

[3] RULE 111: BUSINESS AND OCCUPATION TAX -- ADVANCES AND REIMBURSEMENTS WALTHEW -- LOAN APPLICATION REFUNDABLE DEPOSITS. The Walthew decision is applicable to attorney taxpayers bound by the Disciplinary Rules of the Code of Professional Responsibility, which prohibits them from incurring liability to third party providers in the course of litigation. Service providers other than attorneys will remain subject to the three Christensen requirements for excludability.

[4] RULE 146: BUSINESS AND OCCUPATION TAX -- FEDERAL MORTGAGE-BACKED SECURITIES -- SALE OF -- ACCRUED INTEREST. Amounts received from buyers GNMA, FNMA, AND FHLMC mortgage-backed securities in payment of interest accrued prior to the sale date will constitute deductible "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties" when such amounts have been entered as such in the taxpayer's books of account.

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 PRESENTED BY: . . .
. . .
. . .

DATE OF HEARING: February 24, 1986

NATURE OF ACTION:

Excise tax audits of the taxpayer's books and records resulted in the final assessment of business and occupation tax under the Service classification on the following: (1) gains on the sale of first mortgage loans, (2) interest on federal and state tax refunds, (3) loan application refundable deposits, and (4) interest accrued on GNMA, FNMA, and FHLMC certificates before their sale to third parties.

FACTS:

Bauer, A.L.J.--The Department of Revenue examined the business records of the two above-referenced taxpayers for the respective periods January 1, 1981 through March 31, 1984 and January 1, 1981 through March 31, 1985. As a result of the original audits and several post audit adjustments and payments, the first taxpayer was issued a final credit of $ . . . , and the second taxpayer was awarded credits of $ . . . and $ . . . . The taxpayers have petitioned for a correction of the assessments issued, which would result in larger credits or refunds. In addition, the taxpayer has petitioned for a refund of amounts paid.

The taxpayers were both savings banks. [In April 1985], the first taxpayer acquired the second taxpayer by statutory merger. Their cases have been joined, and the appellants will be referred to singularly and collectively as "the taxpayer."

TAXPAYER'S EXCEPTIONS:

Interest received from GNMA, FNMA, AND FHLMC securities. The taxpayer had initially objected to the assessment of business and occupation tax on income earned from GNMA, FNMA, and FHLMC mortgage-backed securities. The issue has since been resolved by the Department in the taxpayer's favor, and an amended assessment granting a credit has already been issued reflecting this change in position. The subject will thus not be addressed in this determination.

Tax Refund Interest. The taxpayer had erroneously paid a total of $ . . . of B & O Tax on interest received in 1982 and 1983 on Federal income tax refunds and State of Washington Excise Tax refunds. The error was not detected by the auditor in his initial audit. The taxpayer in its original petition sought a refund of those taxes paid, and the Department by post-audit adjustment has already granted a credit in the appropriate amount. Relief having already been granted, the subject will thus not be further addressed in this determination.

Gains from sales of first mortgage loans. The taxpayer has objected to the assessment of service business and occupation tax on gains from the sales of first mortgage loans. The auditor asserted service and other activities business tax on profits or gains that were realized from the taxpayer's sale of mortgages to FHLMC (Federal Home Loan Mortgage Corporation). He reasoned that there was no provision in the law for a business and occupation tax exemption or deduction for gains realized from the sale of a first mortgage, even though interest received from such mortgages is exempt. The auditor explained that the gains thus taxed were excess servicing fees the bank, which is the seller and servicer of the loan, retained over FHLMC's net yield requirement, and that this excess fee averages about 2-3/4 % of the loan value.

The taxpayer made the following argument regarding these first mortgage loan sales in its original petition dated [December 1985]:

> [The taxpayer] sold certain loans secured primarily by first mortgages on nontransient residential properties at a gain during 1982, 1983, and 1984. Most of these gains were not included in the B & O Tax on [the taxpayer's] Washington Combined Excise Tax Returns on the grounds that such gains were deductible under RCW 82.04.4292. The Department's auditor included such gains in the B & O Tax on the theory that the gains do not qualify for the statutory deduction because they do not represent "interest."
>
> The following statutory language of the RCW 82.04.4292 deduction is substantially broader than just "interest" because it includes "amounts derived from" interest:
>
>> In computing tax there may be deducted from the measure of tax by those engaged in banking, loan, security or other financial businesses, <u>amounts derived from</u> interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties. [Emphasis added.]
>
> By including the words "amounts derived from" in the statute, it is clear that the Legislature intended to not restrict the deduction to interest income alone. If the Legislature had intended to limit the deduction to interest alone, it would have said so by merely excluding the key phrase "amounts derived from".
>
> The sale price of a loan is calculated by discounting the cash flow to be received under the terms and interest rate of the loan using the prevailing market interest rate. If the present value of the cash flow results in an amount greater than the seller's cost in the loan, the seller realizes a gain when the loan is sold. A loss to

> the seller is realized when the present value of the discounted cash flow results in a sale price which is less than the seller's cost. For example, assuming a two year, 12 percent simple interest loan (with payments made on December 31st each year) of $1,000 was made on January 1, and then sold 12 months later when the prevailing interest rate was 10 percent, the purchaser would pay $1,018 in exchange for the loan. The $18 gain represents the additional value the 12 percent interest rate loan has in a 10 percent interest rate market. Clearly, the gain on the sale of a loan is directly attributable to the amount of interest.
>
> Thus, the gain is an "amount derived from" interest and is directly within the specific language of RCW 82.04.4292.

By letter dated [November 1986] the taxpayer provided additional information regarding this portion of the assessment:

> Additionally, page 4 of the Petition states that [the taxpayer] paid B & O tax of $ . . . on gains attributable to first mortgage home loan sales which should be refunded.
>
> As set forth on pages 11 and 12 of the Petition, we believe that the statutory language of RCW 82.04.4292 allows a deduction for gains on sales of first mortgage home loans.
>
> However, as I mentioned during our phone conversation, we recently discovered that approximately 75% of the "sold" first mortgage home loans in question were never in fact sold.
>
> This factual discrepancy arose because [the taxpayer] sold fractional interests in a number of first mortgage home loans and retained the remaining fractional interest in those loans. For financial statement reporting purposes generally accepted accounting principles required that the discounted present value of the future interest payments to be received by [the taxpayer] with respect to its retained fractional interest in such loans be reported as a gain even though there was no sale of such retained fractional interests.

> Thus, [the taxpayer] has not received any sale proceeds as to these retained fractional interests because there has been no sale. Further, when such interest is in fact received in future years, [the taxpayer] will be entitled to deduct such interest under RCW 82.04.4292 as interest received on first mortgage home loans.
>
> * * *
>
> The aggregate excess of $ . . . for 1983 and 1984 B & O tax in this schedule (over the first schedule) is attributable to the $ . . . tax refund claimed for this issue on Page 4 of the Petition.
>
> Since we were unaware of this important factual difference at the time the Department of Revenue's auditor examined the books and records of [the taxpayer], we believe that the auditor was also unaware of this factual difference.
>
> For the reasons set forth in the Petition, we continue to believe that the remaining amounts protested in the Petition with respect to the first mortgage home loans that were in fact sold are still entitled to the deduction set forth in RCW 82.04.429.

The taxpayer, by letter dated [January 1986], added:

> ... As the [November 1986] letter states, recently discovered information indicates that approximately 75% of the "sold" first mortgage home loans in question were never in fact sold and, thus, there were not any gains. Accordingly, as to the "non sold" first mortgage loans, we simply don't see any theory by which the "non gains" can be subjected to B & O tax. To the best of our knowledge, the sole reason it is even necessary to include the "non sold" gains for your determination is that the Auditor undoubtedly assumed they were in fact sold because, at the time, we also erroneously assumed they had been in fact sold.

Loan Application Refundable Deposits. The taxpayer has objected to the assessment of tax under the service and other activities business tax classification on loan fee credits it recovered from customers as costs associated with the processing of commercial, residential, and other personal loans.

The auditor in his report noted that the fee, as defined in the taxpayer's accounting manual, included such charges as appraisal and credit reports, and reimbursement of mileage, legal fees and other fees incurred by the bank. He reasoned that the bank was primarily liable for all these expenses, and that such reports are essential documents and/or information the bank has to obtain prior to approval of a loan because they serve the bank in making its loan decision. Thus, the auditor concluded that such amounts were received as part of the taxpayer's personal services performed for a customer and, as such, were subject to tax.

In its initial petition, the taxpayer addressed the subject of these deposits as follows:

> As a financial institution, [the taxpayer] is engaged in the business of making real property loans. In the process of making such loans, the loan applicant completes loan application forms and provides [the taxpayer] with certain information that is necessary to properly determine and document the credit worthiness of the loan applicant.
>
> The loan applicant is also customarily required to pay certain direct costs incurred in making the loan. These costs include amounts for credit reports, title insurance and property appraisals.
>
> As a convenience to its customers, [the taxpayer] and other financial institutions customarily arrange for third parties to provide these services. All such third parties are sophisticated businesses and are well aware of the industry standard that the borrower pays all such costs.
>
> Accordingly, [the taxpayer] customarily requires that the loan applicant "advance" a refundable deposit amount to cover the estimated costs. The typical deposit is approximately $300 for which the loan applicant receives a signed receipt.
>
> [The taxpayer], on behalf of the loan applicant, then pays for such third-party services out of the deposited funds. Any unused deposited funds are

> returned to the loan applicant regardless of whether or not the loan is actually made.
>
> Thus, at all times [the taxpayer] acts as the loan applicant's agent in incurring such costs and the third parties are well aware that such costs are the obligation of the loan applicant.
>
> In the unlikely event that such costs exceed the deposited amounts, then the loan applicant reimburses [the taxpayer] at the time the loan is made. However, if the loan is not made, then [the taxpayer] generally absorbs such excess costs as a matter of sound business policy (even though it has no obligation) because the loan applicant is disappointed since he or she did not get the loan and any such excess amount is usually de minimus.
>
> The Department's auditor erroneously believed such refundable deposits are subject to the B & O Tax.
>
> The refundable deposits that [the taxpayer] receives from loan applicants do not constitute gross income because [the taxpayer] is merely acting as a known intermediary between the loan applicant and third parties.
>
> RCW 82.04.290 only subjects [the taxpayer] to the B & O Tax on its "gross income of the business". Even though such phrase in expansive, it clearly does not include refundable deposits which [the taxpayer] is <u>not</u> legally entitled to retain.
>
> Even under the narrow interpretation of WAC 458-20-111, such refundable deposits clearly qualify as non-taxable "advances". Further, the State of Washington Supreme Court decisions in <u>Christensen v. Dept. of Revenue</u>, 97 Wn.2d 764 (1982) and <u>Walthew v. Dept. of Revenue</u>, 103 Wn.2d 183 (1984) are directly in point and controlling on this precise issue.
>
> Accordingly, the proposed assessment for the Refundable Deposits is clearly erroneous.

At the hearing, the taxpayer reemphasized its position that the situation clearly comes under the provisions of WAC 458-20-111 (Rule 111). It argued that third parties recognize the agency of the taxpayer, and pointed out that potential borrowers do get back any unspent funds.

By letter of [January 1987], the taxpayer again addressed the subject as follows:

> Also enclosed is the form captioned "Receipt for Application Deposit" which you requested. This is the signed receipt which [taxpayer] gives loan applicants for their advance refundable deposits and which is mentioned in the fourth paragraph on page 13 of our original [December 1985] "Petition for Correction of Assessment and Conference and for Refund" on the issue concerning "Refundable Deposits" (the "Petition"). As that Petition indicates, this situation is more clear cut than the situations described in WAC 458-20-111 (which generally pertain to after-the-fact reimbursements) because ...(the taxpayer)... obtains the refundable deposit from the loan applicants <u>prior to</u> advancing funds for the loan applicant's costs and gives this signed receipt for such funds.

The Receipt for Application Deposit contains the following pertinent language:

> My signature below certifies that I understand this Application Deposit will apply to the costs of processing my loan application; i.e., credit report, title insurance and appraisal. If the Bank rejects my application or for any reason I withdraw my request for financing, the Bank will refund only those funds which remain after all loan processing costs have been paid. However, if the loan application is approved, I understand that this Application Deposit will be applied towards my total closing costs.

<u>Taxability of Accrued Interest.</u> As a result of the Department's determination that interest received from GNMA, FNMA, and FHLMC obligations is nontaxable, the Department prepared a post audit adjustment in December 1986. Service tax which had been assessed on monthly interest received from GNMA, FNMA, and FHLMC obligations was deleted. Excluded from the allowable credit, however, was interim interest accrued at the time the securities were sold. The auditor viewed the interim interest as a gain from the sale of the securities; since it was not received from the issuer of the GNMA, FNMA

and FHLMC securities, he did not consider it as "interest received from GNMA, FNMA, and FHLMC obligations."

The taxpayer has responded to this new issue as follows in its letter dated January 12, 1987:

> Regretfully, the enclosed Revised Assessment includes a new issue pertaining to the taxability of interim interest received upon the sale of federalized first mortgage home loans. Accordingly, we hereby protest the Auditor's decision with respect to that item. you will note that the dates and amounts for years 1981 through September 1984 with respect to this issue are set forth in Schedule II-A of the Revised Assessment.
>
> This issue is quite simple. As [the auditor's] December 2, 1986 letter, included with the Revised Assessment, states, "We view the interim interest as a gain from the sale of the securities and since it is not received from the issuer of the GNMA, FNMA & FHLMC securities, it cannot be considered as "interest received from GNMA, FNMA & FHLMC obligations."
>
> The facts are also simple. [Taxpayer] sold a number of federalized first mortgage home loans. When debt obligations (including corporate bonds and United States Treasury Bonds) are sold, the pricing is customarily based upon an agreed amount for the debt instrument <u>plus</u> an amount equal to accrued interest from the last payment date. It is true, as [the auditor's] letter indicates, that the amount equal to the accrued interest is paid by the purchaser of the debt instrument--not the actual debtor. The purchaser pays the accrued interest from the last payment date to [the taxpayer] and on the next scheduled debt payment date receives the interest for such period from the debtor. In fact, the debt obligation purchaser is nothing more than a conduit for [the taxpayer] to collect interest due it for the period of time during which it owned the debt instrument.
>
> Nevertheless, it's not necessary to resolve this issue by determining whether or not the debt obligation purchaser is a conduit because RCW 82.04.4292 specifically states "<u>amounts derived from</u>

> interest" may be deducted in computing the B & O tax. The "interim interest," as [the auditor] calls it, is dollar for dollar and penny for penny the exact same as, is computed by reference to and is solely for the purpose of placing the debt obligation seller in the exact same financial position it would have been if the debtor made daily interest payments. It is difficult to conceive how any amounts could be more directly "amounts derived from" than these "interim interest" amounts. Any other determination would undoubtedly require concluding that the state legislature intended the words "amounts derived from:" to be absolutely meaningless.

ISSUES:

The taxpayer has presented the following three issues for resolution:

1. Whether gains from the sales of first mortgage loans are taxable under the service classification of the business and occupation tax, or exempt as amounts "derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties" under RCW 82.04.4292.

2. Whether refundable loan application deposits are taxable under the service classification of the business and occupation tax or exempt as "advances and reimbursements" under WAC 458-20-111.

3. Whether amounts received from buyers for interest which has accrued on GNMA, FNMA, and FHLMC obligations prior to the date of sale by the taxpayer are taxable under the service classification of the business and occupation tax as gains from the sale of securities, or exempt as amounts "derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties" under RCW 82.04.4292.

DISCUSSION:

1. <u>Gains from the sales of first mortgage loans.</u> The taxpayer has urged that gains realized on such sales are directly attributable to the amount of interest which will be received on the loan which is sold, and thus are "amounts derived from interest received on investments or loans

primarily secured by first mortgages or trust deeds on nontransient residential properties."

The loan interest on which a sales price is calculated, however, is merely a projection. At the time of the sale there has been no "interest received" by anyone. Further, there is no guarantee to either the taxpayer or the buyer that the borrower will not default or prepay, either circumstance resulting in the nonpayment of at least some of the interest which had been projected. Had the legislature intended to exempt amounts received on interest which has merely been projected, the terminology "interest received" would not have been used.

[1] Accordingly, we agree with the auditor's conclusion that the auditor correctly concluded that gains from the sale of mortgages were not "amount(s) derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties," and were thus taxable under the Service classification of the business and occupation tax.

The taxpayer's claim that approximately 75% of the "sold" first mortgage home loans in question were never in fact sold is a factual question which will be referred back to the Audit Section. If participation in these loans were sold, as the taxpayer has indicated, any gains received will, in accordance with the discussion above, be taxable under the service classification of the business and occupation tax.

2. Loan Application Refundable Deposits. The taxpayer has objected to the assessment of tax on loan fee credits recovered from customers as costs associated with the processing of commercial, residential, and other personal loans. The fees cover the taxpayer's direct costs incurred in making the loan, such as credit reports, title insurance and property appraisals.

The taxpayer has argued that, only as a convenience to the customer, financial institutions such as itself customarily arrange for third parties to provide these services, and that all such third parties are sophisticated businesses and are well aware of the industry standard that the borrower pays all such costs. The taxpayer reasons that the taxpayer acts as the loan applicant's agent in incurring such costs, and that the taxpayer is merely acting as a known intermediary between the loan applicant and third party providers. The taxpayer thus concludes that such "advances," which it is not entitled to retain, are clearly exempt from tax under WAC 458-20-111, and that Christensen, 97 Wn.2d 764, and Walthew, 103 Wn.2d 183, are controlling on this point.

Absent a claim that amounts received are "advances," the amounts received by the taxpayer for costs associated with the processing of loans would clearly be taxable under the Service and Other Business Activities classification of the business and occupation tax. This tax is imposed by RCW 82.04.290 upon persons engaged in business activities other than or in addition to those for which a specific rate is provided elsewhere in chapter 82.04 RCW. Such persons are taxable upon the "gross income of the business" defined at RCW 82.04.080 as follows:

> "Gross income of business" means the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses. (Emphasis provided.)

It is abundantly clear that the tax under consideration is a tax on gross receipts; furthermore, it is equally clear that a service provider may not deduct any of its own costs of doing business. The Department has always recognized, however, that sometimes in the regular course of business a taxpayer may pay costs or fees which are properly the obligation of its client or customer, and for which the taxpayer itself has no personal liability. When a taxpayer receives an advance of funds for such a purpose, or when a taxpayer having already expended its own funds for such a purpose receives reimbursement, then such amounts may be excluded from the measure of the tax.

Accordingly, the department has promulgated WAC 458-20-111 (Rule 111) in order to explain the distinction between a taxpayer's own business costs and other payments a taxpayer might make merely as an accommodation for its client or customer. The rule provides in part:

> The word "advance" as used herein, means money or credits received by a taxpayer from a customer or client with which the taxpayer is to pay costs or fees for the customer or client.
>
> The word "reimbursement" as used herein, means money or credits received from a customer or client to repay the taxpayer for money or credits expended by the taxpayer in payment of costs or fees for the client.
>
> The words "advance" and "reimbursement" apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefor, either primarily or secondarily, other than as agent for the customer or client.
>
> There may be excluded from the measure of tax amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession.
>
> The foregoing is limited to cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either on an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. It does not apply to cases where the customer, guest or client makes advances to the taxpayer upon services to be rendered by the taxpayer or upon goods to be purchased by the taxpayer in carrying on the business in which the taxpayer engages.

Strictly speaking, Rule 111 does not provide an exemption or deduction from the business and occupation tax. Nor could it, since there is no statute authorizing such an exemption or deduction. Rather, Rule 111 merely recognized that "advances" and "reimbursements," as defined therein, may be <u>excluded</u> from the measure of the tax because they do not fall within the definition of "gross income of the business."

In Christensen, the court recognized that certain costs which were ostensibly incurred by attorneys in rendering legal services were actually the direct costs of their clients. Consequently, the court held that amounts received by attorneys with which to pay these costs were excludable from the measure of their business and occupation tax pursuant to WAC 458-20-111.

The Christensen court identified requirements for excludability under WAC 458-20-111 as follows:

1. The repayments received by the taxpayer must be reimbursements or advances made as part of the regular and usual custom of the taxpayer's business or profession.

2. The payments made by the taxpayer to associate firms must be for services that the taxpayer does not or cannot render.

3. The taxpayer must not be liable for paying the associate firms except as an agent of the client.

Christensen and the Department stipulated that the first two requirements had been satisfied; the sole dispute involved the third requirement. As to this issue, the parties stipulated that the associate firms understood that they were working for the named client with respect to the work performed. The Department argued that Christensen was nevertheless personally liable for payment to the associate firms. the court found otherwise, based on its interpretation of the general agency rule stated in Restatement (Second) of Agency + 79 comment a. at 200:

> a. Whether or not the agent is authorized to employ agents of the principal depends upon the manifestations of the principal in light of the circumstances, including the usages of the business and of the parties inter se. The agents so employed are the agents of the principal and not of the employing agent, who is not responsible to them for their compensation unless he so manifests, and is no more responsible for their conduct to third persons or to the principal than he is for the conduct of other agents of the principal, unless he is

> negligent in their selection. (Emphasis the court's.)

The Christensen case involved "reimbursements" for money already expended by that taxpayer in payment of costs or fees for its clients. In the present case, the taxpayer normally receives money from its customers prior to paying its outside service providers; such payments are "advances." In our view, the holding and rationale of the Christensen decision apply equally to both "advances" and "reimbursements."

Applying the foregoing Christensen requirements for excludability to the facts of this case, we find that the first two have been satisfied. The evidence reveals that the taxpayer obtains from its clients funds with which to pay third party providers which assist the taxpayer in processing loan applications. This has been the regular and usual custom of the taxpayer's business over the course of many years.

[3] As in the Christensen case, however, the issue here is whether the taxpayer is liable in its own behalf for payment to the outside consultants. Here there is no evidence offered to indicate that the outside consultants recognized that they were to be paid only from funds received from the taxpayer's clients, or that the taxpayer would not be liable to them for compensation if such funds were not received for any reason. Indeed, the taxpayer admits that if a loan is disapproved, it generally absorbs any costs in excess of the advance that has been received as a matter of sound business policy.

There is likewise no evidence to indicate that either the taxpayer's clients or consultants recognized the taxpayer to be dealing with those consultants merely as an agent for those clients, other than the bare assertions that "third parties recognize the agency of the taxpayer" and that potential borrowers get back any unspent funds.

The Receipt for Application Deposit offered into evidence merely constitutes an agreement that the funds advanced will be applied toward certain costs of processing loan applications. The agreement neither authorizes an agency relationship to be used in dealing with these third party providers, nor does it specify that the costs incurred will be solely those of the taxpayer's customer.

Further, even though the taxpayer has argued that third party providers generally recognize that the majority of their fees are in fact paid out of funds received from customers, such is actually the case in most business transactions when a business incurs third party expenses in fulfilling a client contract or customer order. There has been no evidence or testimony offered that would indicate that the taxpayer's customers, the alleged "principals," would be directly billed if payments weren't received from the taxpayer "agent."

Accordingly, we must conclude that the third element required by Christensen has not been met and that the tax was properly due under the rationale of that case.

The more recent Walthew case was issued by the Washington Supreme Court in December of 1984. This case again concerned the excludability of client reimbursements to lawyers. At issue were advances made to third party providers when the lawyer acted as agent for the client, and the client remained ultimately liable for the payment.

In that case, the following factual situation was considered:

> The taxpayer law firm specializes in workers compensation and personal injury cases. Most of its clients are taken on a contingency basis. It is the firm's practice to sign contracts with its clients confirming the client's obligation to pay all court costs, medical or other expenses involved in litigation. The firm customarily paid these expenses, then sought reimbursement from the clients. All loans and advances were carried on the taxpayer's books as assets, representing receivables. When paid, they were listed as reimbursements. If loans or advances were not repaid, they were written off as bad debts. Some clients deposited funds to cover anticipated costs. Such deposits were carried on the taxpayer's books as reimbursements. The taxpayer did not assess any additional costs to clients as part of the repayment to third party providers.
>
> The trial court based its opinion on the Washington code of Professional Responsibility and this court's decision in Christensen, O'Conner, Garrison, & Havelka v. Department of Rev., 97 Wn.d 764, 649 P.2d 839 (1982).
>
> The pertinent section of the Washington Code of Professional Responsibility provides as follows:

> While representing a client in connection with contemplated or pending litigation, a lawyer shall not advance or guarantee financial assistance to his client, except that a lawyer may advance or guarantee the expenses of litigation, including court costs, expenses of investigation, expenses of medical examination, and costs of obtaining and presenting evidence, provided the client remains ultimately liable for such expenses.

In considering both the statute and the rule, the court concluded that reimbursements by clients for the expenses of litigation specifically limited by CPR DR 5-103(B) were not a part of an attorney's gross income for purposes of computing their business and occupation tax. RCW 82.04.080 and Rule 111 were thus construed to exclude from the tax measure reimbursements for litigation expenses when (1) incurred by an attorney acting solely as an agent for the client, and (2) passed through directly to the client without additional charge.

In holding that the attorney acted solely as an agent for its client, the court relied on that profession's Disciplinary Rules of the Code of Professional Responsibility:

> Rule 111 excludes those reimbursements for advances which are merely pass-throughs, where the taxpayer liability, if any, to the third party provider is solely agent liability.
>
> The words "advance" and "reimbursement" apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefor, either primarily or secondarily, other than as agent for the customer or client.
>
> By excluding agent liability, the rule recognizes pass-through payments of the kind involved here. <u>Reimbursements to attorneys for costs of litigation cannot by rules of this court constitute compensation</u>. Lawyers are bound by the Disciplinary Rules of the Code of Professional Responsibility. DR 5-103 prohibits a lawyer from financing the costs of litigation unless a client remains ultimately

> liable for those costs. <u>Thus an attorney must because of this rule act solely as agent for the client when financing litigation. Attorneys are unique in this respect. The Department's concern that other professionals will necessarily gain an exemption by our holding is misplaced.</u> (Emphasis added.)

Thus, the Court in <u>Walthew</u> found that attorneys are unique among service providers in that they are bound by the Disciplinary Rules of the Code of Professional Responsibility, which prohibits them from financing the expenses of contemplated or pending litigation unless the client remains ultimately liable for such expenses. Attorneys, because of this rule, can act only as agents for their clients when financing litigation.

[3] Accordingly, the Department necessarily interprets the <u>Walthew</u> decision to be applicable only to attorney taxpayers bound by the Disciplinary Rules of the Code of Professional Responsibility, which prohibit them from incurring liability to third party providers. Other service providers will remain subject to the three <u>Christensen</u> requirements for excludability. The taxpayer, being one of these other service providers, is not affected by the <u>Walthew</u> decision. Therefore, relief cannot be granted.

<u>Taxability of Accrued Interest.</u> The taxpayer has argued that amounts received from the purchasers of GNMA, FNMA, and FHLMC securities for interim interest which had accrued before their sales is properly nontaxable under RCW 82.04.4292. The auditor, on the other hand, considered such payments as part of the gain from the sale of the securities, since it was not received from the issuer of the various securities.

The GNMA, FNMA, and FHLMC obligations here at issue bear a guaranteed fixed interest rate payable monthly to the holder. Thus, interest on these securities accrues to a security holder from one payment to the next. It is generally recognized that when an accrual basis taxpayer has recognized, or is required to recognize, such accrued interest in its books of account, it has "received" such amount for state tax purposes. See WAC 458-20-199. Therefore, we hold that such interest is "interest received."

The second inquiry, then, is whether the "amount" at issue has been derived from this "interest received." Testimony has indicated that the "amount" in question, which is received from the buyer, is based on and is equal to the interest which has been accrued by the seller prior to the date of the security's sale. In addition, this amount is normally recorded by both buyer and seller in their respective interest accounts. When such circumstances are present, we conclude that the amount received by the seller is indeed "derived from" the "interest" which it had "received."

[4] Accordingly, amounts received from buyers of GNMA, FNMA, and FHLMC mortgage backed securities in payment for interest accrued by sellers prior to the sale date will constitute "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties," and will be deductible from the measure of the Business and Occupation tax which such accrued interest had been entered as such in the taxpayer's books of account.

This conclusion is analogous to the rule set forth in WAC 458-20-162 regarding the taxation of accrued bond interest, which provides in pertinent part:

> Interest accrued upon bonds or other securities sold shall be included in gross income where such interest is carried in an interest account and not as part of the selling price. Conversely, interest accrued upon bonds or other securities at the time of purchase may be deducted from gross income where such interest is carried in an interest account and not as a part of the purchase price.

Additionally, although not binding under Washington's tax law, we note that the federal income tax law provides similarly. When bonds are sold between interest dates and part of the sales price represents interest accrued to the date of the sale, that amount must be reported as interest income by the seller. Treas. Reg. § 1.61-7(d). When a bond is purchased when interest had been accrued but not paid by the seller, such interest is not income and is not taxable as interest if subsequently paid to the buyer. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued (depending on the method of accounting used by the taxpayer). Reg. § 1.61-7(c).

DECISION AND DISPOSITION:

The taxpayer's petition for correction of assessment is denied in part and granted in part. The Audit Section, after making the adjustments indicated by this determination, will issue an amended assessment, payment of which will be due on the date indicated therein.

DATED this 20th day of September 1989.