Cite as Det. No. 92-392, 12 WTD 535 (1992)

THIS DETERMINATION HAS BEEN OVERRULED OR MODIFIED IN WHOLE OR PART BY DET. NO. 98-218, 18 WTD 46 (1999)

BEFORE THE INTERPRETATION AND APPEALS DIVISION
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 of	)	
	)	No. 92-392
	)	
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .
	)	

[1] RCW 82.04.4292 -- Rule 146 -- REQUIREMENTS. The deduction available under RCW 82.04.4292 is available only when all of the following conditions are met: (1) The taxpayer is engaged in banking, loan, security, or other financial business; (2) the amounts received are derived from interest; (3) on an investment or loan; (4) primarily secured by a first mortgage or deed of trust; (5) on nontransient residential real property.

[2] RCW 82.04.4292 -- Rule 146 -- INTEREST. Interest is the charge for the use or forbearance of money. Citing: Security Savings Society v. Spokane County, 11 Wash. 35 (1920).

[3] RCW 82.04.4292 -- Rule 146 -- INTEREST. Where a financial business originates loans secured by first mortgages on nontransient residential real property and then sells the principal portion of the mortgages and a part of the interest portion while retaining a part of the interest stream, the retained part is still income derived from interest on a loan primarily secured by a first mortgage on nontransient residential real property and deductible from gross income for business and occupation tax purposes. DISTINGUISHING: Det. No. 89-474, 8 WTD 259 and Det. No. 90-141, 9 WTD 280-29.

[4] GROSS INCOME OF A BUSINESS. The gross income of a business does not include mere accounting entries of imputed amounts. Gross receipts must be actually or constructively received to be taxable. Citing: Weyerhaeuser Co. v. Department of Rev., 106 Wn.2d 557 (1986).

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .

DATE OF HEARING: . . .

NATURE OF ACTION:

A bank protests the assessment of business and occupation taxes on its retention of part of the payments received from loans secured by first mortgages and deeds of trust which were sold on the secondary market.

FACTS:

Heller, A.L.J.[1] -- The taxpayer is engaged in the banking business. A major portion of the taxpayer's business consists of making loans secured by first mortgages or deeds of trust on nontransient residential real property. These loans are "pooled" and sold in the secondary mortgage market under federal mortgage-backed guarantee programs such as GNMA, FNMA, and the like. Investors purchase certificates representing undivided interests in these pools. These investment certificates are commonly referred to in the financial industry as "mortgage-backed" securities.

The taxpayer was assessed business and occupation tax ("B&O tax") on amounts received or accounted for by the taxpayer in connection with its lending activity during the period of January 1, 1985 through December 31, 1988.

A loan represents an investment made by the taxpayer either out of its reserves available for lending or from funds borrowed from third parties. From the taxpayer's perspective, loans consist of two basic economic components. The first component is the principal invested which the borrower is obligated to repay according to the terms of the borrowing instrument. The second component is the return on the taxpayer's investment reflected in the interest paid by the borrower for the use of the taxpayer's funds. Interest is typically paid over the life of the loan at the time periodic payments of principal become due according to a predetermined repayment schedule.

The rate of interest charged by the taxpayer is influenced by many different factors. Some of these factors include the taxpayer's direct and indirect costs of making the loan such as the interest expense of acquiring funds to make the loan as well as salaries, rent, supplies, and the like. The interest rate also depends upon external factors such as market driven competitive forces and various risks assumed by the taxpayer in making the loan. The risks of making the loan include: the risk that the cost of the funds borrowed to make the loan will exceed the interest charged the borrower; the

[1] Coffman, A.L.J., participated in the decision.

risk that the loan will be repaid earlier than predicted thereby reducing the taxpayer's

return on investment; and ultimately, the risk that the borrower will default and a sale of the collateral will be inadequate to give the taxpayer its anticipated return. Each of these costs incurred and risks assumed make up a part of the taxpayer's investment in the loan. Whether a given loan is profitable depends upon how accurately the taxpayer can assess these risks in setting the interest rate.

The nominal or stated interest rate for a given loan may differ from the actual rate of interest charged the borrower. Often, the taxpayer will charge a "loan origination fee" or a "discount fee" which the borrower pays in a lump sum at the time the loan agreement is entered into. For financial accounting purposes the taxpayer is required to treat these fees as prepayments of interest which result in a higher effective yield on a given loan than the rate of interest stated in the borrowing instrument. According to the taxpayer, setting the amount of loan discount in a particular loan is largely a pricing function and depends upon various market factors including an individual borrower's desire for a lower stated rate of interest.

When the taxpayer receives loan discount fees it is required by generally accepted accounting principles ("GAAP") to capitalize these amounts and recognize them as income ratably over the life of the loan. According to the taxpayer, accounting for the loan discount in this manner results in a more accurate matching of income and expense associated with the loan. At the time a loan is repaid in full, sold or otherwise disposed of, the taxpayer is required by GAAP to include in income any remaining portion of discount fees attributable to the loan.

The taxpayer deducts the loan discount fees it receives in computing its B&O tax on the theory that these amounts constitute deductible interest. Likewise, the taxpayer does not report as taxable any of the ratable portions of the loan discount as they are later brought into income for financial reporting purposes.

When the taxpayer sells a loan it may sell the loan in its entirety, or retain a portion of a loan and sell the remainder. This sale transaction may take one of the following forms:

(a) The taxpayer may sell the entire loan, so that the taxpayer no longer has the right to receive any of the principal or interest paid by the borrower.

(b) The taxpayer may retain part of the principal and a proportionate amount of the stated interest rate in the note. The balance of the principal and interest is transferred to the investor.

(c) The taxpayer may retain all of the principal portion of the loan (called a "PO," or "principal only strip"), and transfer all of the interest portion of the loan (called an "IO," or "interest only strip").

(d) The taxpayer may retain all of the interest portion of the loan ("IO strip"), and transfer all of the principal portion of the loan ("PO strip").

(e) The taxpayer may retain part of the interest portion of the loan, and transfer the remaining interest portion and all of the principal portion of the loan. When the taxpayer sells the principal and a portion of the interest, it continues to be secured by the first position deed of trust as to the retained interest stream. These transfers are sometimes, but not always accomplished using mortgage-backed securities.

This appeal involves those loans where the taxpayer did not transfer all of its rights in loans it originated as lender. The loans (or portions of loans) which are sold return a specified yield to the investor. This yield is generally lower than the original interest rate the borrower agreed to pay the taxpayer. As a part of the sales arrangement, the taxpayer agrees to continue collecting the borrower's payments on the loans. As the payments are made, the taxpayer collects the full payment made by the borrower, passes on to the investors the interest and principal related to the portion of the loan sold to them and retains the balance. This retained portion of the payment is recorded in the taxpayer's records as "loan service fees."

The following is a typical fact pattern: The taxpayer makes a loan secured by a nontransient residential first mortgage. According to the loan documents, the taxpayer is entitled to receive -- and the borrower is obligated to make -- repayment of the principal and payments of interest throughout the repayment period of the loan. The taxpayer retains its right to receive part of the principal and/or interest, and transfers to other investors the right to receive the rest of the principal and/or interest. After the transfer, the lender continues to receive the payments from the borrower in their entirety. The taxpayer, however, retains only that portion of the borrower's payment that corresponds to its rights under the retained portion of the loan and passes the rest on to the investors.

In cases where the taxpayer has transferred the right to receive all of the principal to the investors the auditor assessed tax on the portion of the payment retained by the taxpayer under the service and other activities classification. The auditor takes the position that these amounts represent taxable fees for services rendered to the investors and not interest deductible from the measure of the B&O tax.

When the taxpayer sells part of the loan, the transaction generates a gain or a loss, depending on whether the amount received by the taxpayer is greater or less than the taxpayer's cost of making that portion of the loan. The difference between the amount received and the taxpayer's cost, if any, is recorded in the taxpayer's records as "gain on commitments." This entry represents actual revenues from actual sales transactions. The auditor assessed tax on all amounts recorded in this entry. A portion of the "gain on commitments" entries taxed by the auditor were discount fees received by the taxpayer from borrowers in connection with loans which the taxpayer reflected as income.

In addition, the taxpayer, in accounting for the portions of the loan retained, is required by GAAP to account for and record an imputed gain which reflects the present value of the stream of payments estimated to be received in the future from the portion of the loan held. This entry, according to the taxpayer, does not reflect the actual receipt of proceeds from the loan, but instead is an accounting entry estimating the economic value of the loan. These amounts are recorded in the taxpayer's books as "gain on sale of loan." The auditor assessed tax on these entries on the theory that they represented actual receipts or accruals of revenues.

TAXPAYER'S EXCEPTIONS:

The taxpayer argues that in computing its B&O tax liability it is entitled to deduct the retained portion of the borrower's payment. According to the taxpayer, the retained portion is interest on loans secured by first mortgages on nontransient residential properties deductible under RCW 82.04.4292. In a similar case the taxpayer's representative stated in support of this position:

> The borrowers are obligated to repay the principal amount of the loans, and to pay interest at an agreed rate until the principal is repaid. As with all loans, the interest is intended to compensate the lender for the time value of the money lent, the risk of nonpayment, and the costs of servicing the loan. Those elements are inherent and present in the interest paid by the borrower throughout the life of the loan. That is true whether the original lender retains the loan, transfers all of it, or retains part and transfers part.
>
> Therefore, when the Taxpayer pledges a mortgage as security or transfers the right to receive some part of the interest and principal, the taxpayer continues to receive the borrower's payments of principal and interest. The Taxpayer retains a portion of the interest that it receives from the borrower, and pays over the remaining interest and principal to the transferees who have become entitled to those portions.

As to the assessment of tax on the gain on sale of commitments the taxpayer does not dispute the fact that a taxable gain exists due to the sale of the loan, but appeals the measure of tax. This issue focuses on that portion of the amount realized on the sale of a loan which is attributable to an accounting adjustment in the book value of the loan resulting from the receipt of loan origination fees or discount points.

As to the final issue, "gain on sale of loan" the taxpayer's petition states:

> First, the auditor proposes tax in Schedule II on accounting entries that do not represent any actual transaction or receipts -- they are imputed or constructive entries for internal accounting purposes, per generally accepted accounting principles. Second, those constructive entries pertain not to Portion B, which was sold, but to Portion A, which the Taxpayer still owns. The auditor was understandably misled by the labels the Taxpayer used for these entries and, for lack of understanding the transactions, erred by basing the proposed assessments on those labels.
>
> [A]bove, we described the accounting entry reflecting the sale of Portion B, which is called "gain on commitments," and represents an actual receipt, and would be taxable if it is not deductible interest. At the same time, other accounting entries are made that pertain to Portion A, which the taxpayer still owns. The entries we are

> examining here do not represent <u>any</u> actual receipts from <u>anyone</u>. Rather, these entries relate to the <u>future interest payments the borrower</u> is expected to make to <u>the original lender, the Taxpayer</u>, as required by the mortgage note. The Taxpayer will continue to receive and retain a portion of those interest payments by virtue of the Taxpayer's retention of Portion A of the loan.
>
> An attempt has been made to estimate how much interest the Taxpayer will receive from the borrower in the series of monthly payments that make up Portion A. Those interest payments will continue until the borrower pays off the loan in full. Therefore, an estimate must be made of how long that stream of interest will continue -- that is, when the borrower is likely to pay off (or, generally, prepay) the loan -- e.g., 12 years. Next, an adjustment must be made for the fact that those payments will be received over a period of years in the future; therefore, they must be reduced by use of an assumed discount rate that, it is hoped, will approximate the actual present value of this indefinite, potential income stream. An entry is made equal to part of that approximate present value of the future interest payments that comprise Portion A. That estimate is entered in an account that was labeled "gain on sale of loan" -- despite the fact that the Taxpayer has received <u>no revenue whatsoever</u> as to Portion A, let alone received a gain. In fact, the Taxpayer's potential receipt of any particular amount of the future interest comprising Portion A and (therefore, this entry) are sufficiently speculative that it does not qualify as an accrual for tax accounting purposes.
>
> The B&O tax applies only to actual revenues, not to internal bookkeeping entries of "constructive" or imputed amounts. <u>Weyerhaeuser Co. v. Department of Revenue</u>, 106 Wn. 2d 557, 564-566, 723 P.2d 1141 (1986). Because the Taxpayer in the present appeal had no actual revenues (either received or accrued) corresponding to the accounting entries, those entries are not subject to B&O tax. Just as in <u>Weyerhaeuser</u>, that is true despite the existence of the bookkeeping entries, the label used for them, or the fact that they may be required to conform to applicable accounting principles. The assessments proposed in Schedule II should therefore be canceled.

(Emphasis in original.)

DISCUSSION:

1. <u>RETAINED INTEREST INCOME.</u>

The B&O tax is imposed on the privilege of engaging in business in this state and is computed classifying the type of activity according to statutory definitions and then applying specific tax rates to the gross income of the business. RCW 82.04.220. 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 and are taxable at the rate of 1.50% of gross income. RCW 82.04.290 and WAC 458-20-146. Gross income is defined to include:

> "Gross income of the 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, <u>interest</u>, 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 added.) RCW 82.04.080.

A deduction from gross income is permitted in computing tax for those persons engaged in the financial and banking business for amounts derived from interest on certain loans.

[1] RCW 82.04.4292 provides as follows:

> In computing tax there may be deducted from the measure of tax by those engaged in banking, loan, security or other financial businesses, amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties.

WAC 458-20-146 ("Rule 146") restates this deduction verbatim. Therefore, to qualify for the deduction the following requirements must be satisfied:

1. the taxpayer must be engaged in banking, loan, security, or other financial business;
2. the amounts received are derived from interest;
3. the amounts derived from interest are from an investment or loan;
4. the taxpayer's loan or investment is primarily secured by first mortgage or trust deed; and
5. the first mortgage or trust deed must create a security interest in nontransient residential real property.[2]

Here, there is no question that the taxpayer meets the first requirement as a bank. There is also no doubt that the loans in question are primarily secured by first position deeds of trust on nontransient real property satisfying the fourth and fifth requirements. The question presented by the taxpayer's first exception to the assessment is whether the portion of the borrower's payment retained by the taxpayer from the loans at issue is an amount derived from interest and whether this receipt is from a loan or investment made by the taxpayer. In addition, a question is raised: to what extent the amounts retained by the taxpayer are for servicing the loans and therefore not interest.

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[2] The Department has held that the person claiming the deduction must hold a beneficial interest in the first mortgage or deed of trust.

RCW 82.04.4292 is an exemption provision. In Budget Rent-a-Car of Washington-Oregon, Inc. v. Department of Rev., 81 Wn.2d 171 (1972) the Court stated:

> Exemptions to a tax law must be narrowly construed. Taxation is the rule and exemption is the exception. Anyone claiming a benefit or deduction from a taxable category has the burden of showing that he qualifies for it.
>
> Exemptions thus do no more than carve out of the general law imposing the tax a narrow niche where the tax law does not reach.

(Citations omitted.) Id. at 174-5.

This rule applies only where the statutes in question are ambiguous. In this case we feel the language is clear when the definition of interest has been clarified.

a. Amounts Derived from Interest.

[2] RCW 82.04.080 defines the term "gross income from business" in an all-encompassing manner and specifically includes interest. However, the Revenue Act does not define the term "interest."[3]

The Supreme Court of Washington, in discussing a legislative change in the rate of interest applicable to delinquent taxes, noted that:

> Interest is merely a charge for the use or forbearance of money.[4]

Security Savings Soc. v. Spokane County, 111 Wash. 35 (1920).

When the taxpayer makes a loan by advancing funds to the borrower it receives a direct and primary right to repayment of the principal along with interest according to the terms of the loan instrument. The amount received in addition to the repayment of principal is clearly for the use of money, and therefore, constitutes interest under the foregoing definition. This right to receive repayment of principal and interest is a valuable asset recorded on the taxpayer's books and has a variety of components of value all of which belong to the taxpayer. The loan is not just the right to receive a repayment of the funds advanced, but also the right to compensation for the taxpayer's investment in the loan.

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[3] Although the statute talks in terms of "amounts derived from interest," for purposes of the deduction such amounts must necessarily include interest itself.

[4] The term forbearance as used in this context is defined as the "[a]ct by which [a] creditor waits for payment of [a] debt due by [a] debtor after it becomes due . . . . Indulgence granted to a debtor." Black's Law Dictionary 5th ed. 1979 (citations omitted - brackets supplied.)

In some cases the taxpayer chooses to sell a certain combination of these rights to an investor for a price determined according to a market established for these types of instruments. This sale is accomplished through the assignment of some, but not all, of the taxpayer's rights in the note and deed of trust representing the loan. The fact that the taxpayer sells part of the asset does not affect the primary and direct nature of the borrower's obligation to the taxpayer as to the portion of the loan retained. As interest accrues on the loan, a portion of this amount becomes a debt owing from the borrower to the taxpayer. The taxpayer may still resort to foreclosure in the event of a default of the note or deed of trust by the borrower, and the taxpayer may still sue the borrower for a deficiency if the sale of the collateral is not sufficient to satisfy the taxpayer's right to payment.

From the perspective of the borrower the portion of the payment in excess of the principal amount is in fact interest paid for the use or forbearance of money. Credit was extended by the taxpayer to the borrower in exchange for a promise to repay the principal amount plus interest. The character of the payments made by the borrower does not change merely because all or a portion of the right to receive the payment has been assigned to an investor. Provided the borrower continues to make timely payments and abide by the other covenants of the loan agreement, the taxpayer, or its assignee, is not entitled to accelerate repayment of the loan. This payment is certainly for the "use or forbearance of money." In fact, the borrower is, in most cases, entitled to deduct this amount for federal income tax purposes as qualified residence interest.[5]

[3] To conclude that the amounts received are not interest would create an anomaly in the tax law which we do not think was contemplated by the legislature. Such a conclusion would mean that amounts which are plainly interest to the borrower are nonetheless not interest to those who have the right receive it under the terms of the borrowing instrument.[6] We conclude that the amounts in question constitute interest within the meaning of RCW 82.04.4292.[7]

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[5] I.R.C. section 163(h)(3).

[6] The artificial distinction created by focusing on who holds the "principal" can be illustrated in the case of negative amortizing loans and certain compound interest situations. Under the terms of a negative amortizing loan a portion of the interest is deferred and added to principal. If a lender retained only an interest portion in such a loan, and some of the interest due the lender was deferred, the deferred portion would create principal making some of the interest eligible for deduction as "interest." Apparently, the balance of the payment to the lender would not be eligible for deduction because it would not be "interest" attrib- utable to retained principal. Loans with a negative amortizing feature were common during the early 1980's when interest rates exceeded 15%.

A similar conceptual problem exists with all loans which accrue interest using a compounding period shorter than the interval between payments. Because interest earned during the compounding period constitutes a debt due the originating lender and thus becomes part of the measure for the application of interest for the rest of the payment period, isn't the later "interest" being paid for the use of the originating lender's money regardless of whether or not the originating lender has assigned the "principal" of the loan?

[7] Because we conclude the amounts at issue are interest, we do not need to decide the meaning of the phrase "amounts derived from interest."

Excise Tax Bulletin 463.04.146 ("ETB") addresses the taxability of amounts received from a borrower for interest when a loan is sold. According to the ETB, interest on loans or investments is to be divided among the originating lender and the investors in relation to the portion of the loan sold and the portion of the loan retained. The ETB does not directly address a situation where an originating lender sells a portion of a loan where the purchaser's rights to receive principal and interest are in different proportions. Presumably, however, in allocating interest in relation to the portions to the loan sold and retained, the ETB was referring to interests in the entire loan and not just the principal amount. Given that a loan is not just the right to repayment of principal, but an entire bundle of economic rights each of which can be separately assigned, we do not think this ETB can be read to require an allocation of interest income according to the amount of original principal held. Instead, the ETB is recognizing the differing ownership rights of the originating lender and the investor and requiring an apportionment of the interest income in accordance the respective ownership of each.

On two occasions the Department has considered appeals involving situations similar to the facts here. In both cases the Department denied interest treatment to the taxpayer finding that the retained interest was properly taxable as trading gain on the sale of loans in question. In Det. No. 89-474, 8 WTD 259 (1989), the taxpayer was engaged in the business of making loans primarily secured by first deeds of trust on nontransient residential real property. As part of an integrated transaction, the taxpayer transferred to its parent corporation the entire interest in loans the taxpayer originated. The parent in turn pooled the loans and sold them to investors retaining the "spread" between the stated interest rate on the loans and the rate offered to the investors. The parent then calculated the value of the spread over the anticipated life of the loan and paid this "premium" to the taxpayer in a lump sum. The premium was payable in all events and was not contingent upon the payment of the spread by the borrower. The Department concluded that the taxpayer had not retained any interest in the loan and the premium received was taxable as gain on the disposition of the taxpayer's entire interest in the loans.[8] Det. No. 89-474 is distinguishable from this case as the taxpayer here has not transferred its entire interest in the loans nor has it received a payment from anyone which accelerated its right to receive interest from its borrowers.

Det. No. 90-141, 9 WTD 280-29 (1990) involved a taxpayer originating loans and then pooling and selling them on the secondary mortgage market. According to the determination, after the loans were sold the taxpayer continued to collect the payments from the borrower in exchange for a small amount of the interest collected from the borrower. The Department concluded that the taxpayer in that case did not retain an interest in the loan and that the amounts it received for collecting the payments on behalf of the investors constituted a "premium" taxable as trading gain. The determination does not indicate the nature of the taxpayer's right to the amounts received other than to state that the taxpayer disposed of its entire interest in the loans at issue. In reaching this

[8] The determination did not address the taxability of the receipt of interest on the "spread" retained by the parent as the borrower made payments.

conclusion the Department stated:

> Only the owner of a first mortgage home loan may report and deduct interest received on that loan. If the entire loan is sold to another, only the new owner may report and deduct the interest received, since only the new owner's money is being used by the borrower (the "old" owner having been repaid by the "new" owner). <u>If an element of interest is retained by the seller of a loan as a result of the contract of sale between the old and new owner</u> - even though no portion of the loan has been retained by the old owner - <u>that interest is a premium properly taxable as a gain</u>. It then follows that, <u>when only a portion of a loan is sold, interest received attributable to the retained portion may be properly deducted by the owner of the retained portion.</u>

(Emphasis added.)

The taxpayer in the present case did not sell its entire ownership interest in the loans at issue. Furthermore, the "retained interest element" in this case was not the "result of the contract of sale between the old and new owner." The taxpayer here simply did not sell the portion of the loan it still holds.

It would not be appropriate in this case to treat the interest received from the borrower as taxable "gain." Gain as the term is used in this context refers to the net difference between the gross proceeds from the sale of a loan or security and the taxpayer's investment in the loan sold. This net difference is included within the definition of "gross income of the business" under RCW 82.04.080.

Implicit in the term gain is the realization of a benefit, typically in the form of money, by reason of the disposition of an asset. Here the interest received from the borrower is not paid by reason of the disposition of a portion of the loan, but instead because the taxpayer loaned funds to the borrower. In addition, the proceeds from a sale are paid by or for the benefit of the person acquiring the purchased item. The payment of the interest at issue arises out of a relationship between the borrower and the taxpayer which is completely independent of the investor's purchase of a portion of the loan.

b. Investment or Loan.

As indicated above, each loan recorded on the taxpayer's books is an asset representing the commitment of funds and the undertaking of risks by the taxpayer. In this sense the taxpayer has made a loan satisfying the third requirement for deductibility. This loan continues to be outstanding after the assignment and it is with respect to this loan that the borrower makes payments. But even if the sale of the principal part of the loan causes the amounts received to be so attenuated from the loan so as to not constitute interest on a loan, the taxpayer still has a continuing investment to which the payments are attributable.

The costs incurred by the taxpayer are not fully recovered by the assignment of a portion of the loan even if the taxpayer has recovered the principal amount of the loan. In some cases a portion of a loan is sold at a gain where the taxpayer receives an amount in excess of its investment in the portion of the loan sold. However, the taxpayer is still looking to the balance of the loan retained in order to fully compensate it for the risks it continues to bear throughout the life of the loan as well as any residual costs it has not recovered. A continuing investment in the loan is sufficient to support a deduction under RCW 82.04.4292 of any interest received with respect to such investment.

Having found that each of the requirements of RCW 82.04.4292 have been met with respect to the amounts received by taxpayer as the owner of a portion of the loans in question, we conclude that the amounts at issue are deductible interest.

2. SERVICING FEES.

The auditor took the position that the amounts retained by the taxpayer were consideration for servicing the loan, and therefore, not deductible interest. This position is not surprising in light of the fact that the account under which the taxpayer recorded these amounts was entitled "loan servicing fees." However, we are not bound by the accounting labels which the taxpayer attaches to items of income and expense.

As part of its arrangements with the investors the taxpayer is required to continue to collect the borrower's payments and distribute the proceeds to the investors in accordance with the ownership interests in the loan. When the taxpayer, as the original lender, held the entire interest in the loan, the interest it received from the borrower compensated it for its risks and costs of making and maintaining the loan. The portion of the borrower's interest payments retained by the taxpayer continue to compensate the taxpayer for its risks and costs. We do not believe that the amounts retained by the taxpayer are consideration for servicing the loan for the following reasons:

a. The agreements governing the assignment between the taxpayer and the investor did not treat the amount retained by the taxpayer as anything other than interest. We are unable to identify in the agreements with the investors where the interest collected from the borrower was a bargained for consideration specifically for the rendering of collection and distribution services.[9]

b. The cost of servicing a loan is generally fixed regardless of the amount of the loan outstanding. Interest, on the other hand, is directly proportionate to the amount of the loan. It is not consistent with the characterization of a servicing fee that the taxpayer receive a large fee for servicing one loan and a relatively small fee for servicing another even though they entail exactly the same service rendered by the taxpayer.

c. The taxpayer produced evidence at the hearing that the investors could obtain the same

[9] This situation should be contrasted with an arrangement where a lender sells its entire interest in a loan and pursuant to its agreement with the investor collects the entire payment on behalf of the investor, out of which it is entitled to retain some portion as a fee. This is not such a case.

service from a subservicing agent for a nominal yearly fee bearing no relationship to the amounts received from the borrowers and retained by the taxpayer.

d. Most importantly, the taxpayer still has a vested interest in continuing to collect the borrower's payment for its own benefit as an owner of the loan. If the taxpayer did not continue to collect payments, it would have to engage the services of a subservicing agent on its own behalf.

We believe that where the agreement between the originating lender and the investors does not call for services to be provided for a specific fee (as distinguished from the originating lender's retained share of the borrower's interest payments) and the servicing is merely incidental to the distribution of the payment between the lender and investors, then the amount retained constitutes interest and not a separately earned fee for services.

3. GAIN ON SALE OF MORTGAGES.

We now turn our attention to the taxpayer's argument that the amounts assessed for gain on sale of loans improperly included amounts which were interest. When the taxpayer initially lends funds to a home buyer it charges loan origination fees and discount points which are paid at the time the loan is made. As previously mentioned, net loan origination fees and the discount points are treated as an adjustment to yield under the provisions of Financial Accounting Standards Board directive 91 ("FASB 91"), issued December 1986. FASB 91 requires the taxpayer to recognize net loan origination fees and discount points over the life of the loan. We held in Det. No. 89-280, 7 WTD 375 (1989), that under these circum- stances the charge for net loan origination fees and discount points are interest when received and, therefore deductible, when the other requirements of RCW 82.04.4292 are met. When the taxpayer sells all or a portion of a loan, it will recognize for financial accounting purposes the previously unrecognized portion of these items that relate to the portion sold. Because these items were deductible interest under RCW 82.04.4292 when received, we fail to see how the later accounting adjustment, when a loan is sold, changes the character of the earlier deductible receipt into a taxable one. The accounting adjustment is not the receipt of funds. Therefore, in computing gain on the sale of loans in situations such as this, the amount of net loan origination fees and discount points recognized do not constitute gross receipts on the sale.[10]

[10] In computing gain or loss on the loans at issue, the taxpayer allocated the entire amount of the principal to the portion of the loan sold consistent with its characterization of the transaction. For federal income tax purposes these trans- actions are treated as stripped mortgages and gains or losses are computed by allocating the principal, or "basis", between the sold and retained portions. Rev. Rul. 91-46, 1991-2 C.B. 358; see, e.g., I.R.C. §1286. The Internal Revenue Service requires such an allocation because in its opinion the continuing interest of the originating lender and the resulting gain or loss on sale of the instrument is more clearly reflected. Based on similar reasoning, it has been suggested by the Audit division that such an allocation is required in this case. We decline to decide the issue in this determination for several reasons. First, a reallocation of principal in this case would require us to remake the parties' agreement; an action we hesitate to take. Second, and most importantly, the decision whether to impose a allocation obligation on home mortgage lenders "basis" should be considered in a rule-making context, not in the context of a taxpayer's appeal deter- mination. The complexity and potentially far reaching consequences of imposing such an allocation requires a more fully developed factual and legal record than is available here. We note that regardless of how this issue is resolved the taxability of the taxpayer's receipt of the borrower's payments in this case remains unchanged.

4. IMPUTED AND CONSTRUCTIVE INCOME.

[4] The taxpayer records in its books the estimated amount it will receive from the retained portion of the loan. This deferred asset is based on the estimated number of interest payments, an assumed future interest rate for present value calculation, and considers the probability that the loan will be prepaid. These calculations are sufficiently speculative that they are not treated as actually accrued for federal tax purposes. The auditor found that the entries of these deferred assets constituted taxable receipts. As previously stated, RCW 82.04.080 defines gross income from the business as:

> [T]he value proceeding or accruing by reason of the transaction of the business engaged in. . .

(Emphasis added.)

The value proceeding or accruing is the amount "actually received or accrued." RCW 82.04.090. The Department was instructed in Weyerhaeuser, supra, that it may not modify the terms of a contract to impute interest when there is none in the contract. Likewise, the Department may not tax accounting entries which do not reflect actual receipts or which are not currently recognized under the normal rules of accrual accounting. Thus, amounts recorded on the taxpayer's books as "gain on sale of loan" and which reflect imputed amounts as described above, are not actual income and are not subject to taxation.

DECISION AND DISPOSITION:

The taxpayer's petition is granted. The file will be returned to the Audit Division to make adjustments consistent with this determination.

DATED this 24th day of December 1992.