Cite as Det. No. 92-345, 12 WTD 501 (1992).

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

In the Matter of the Petition For Correction of Assessment of	D E T E R M I N A T I O N
	No. 92-345
. . .	Registration No. . . .
	. . ./Audit No. . . .

[1] RULE 106 - MERGER - GAAP REQUIREMENT FOR SUBSTITUTED BASIS OF ASSETS - NO REALIZATION OF GAIN. Among nontaxable asset transfers cited in Rule 106 are transfers "pursuant to a reorganization under 26 USC Section 368 of the Internal Revenue Code, when capital gain or ordinary income is not realized." Even though GAAP might require a substituted basis for assets acquired in merger, only the historical cost basis will be used to calculate gain/loss for B&O tax purposes when these assets are eventually sold. Partial Accord: Det. No. 87-212, 3 WTD 259, 264 (1987).

[2] RULES 109 and 146: B&O TAX - INTEREST - SALE OF LOAN - INTEREST V. PREMIUM. If a portion of interest is paid over to the seller of a loan by the buyer of the loan -- even though no portion of the loan has been retained by the seller -- that interest is a premium properly taxable to the seller of the loan as a gain. The buyer of the loan is taxable - absent a deduction - on that portion of the interest retained by or paid over to the seller of the loan. Accord: Det. No. 90-141, 9 WTD 280 (1990).

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: . . .

NATURE OF ACTION:

Petition concerning the effect of a bank merger's "purchase method" accounting on the calculation of gain on the sale of investments, and the interest differential paid over to dealers by the purchaser of their loans.

FACTS:

Bauer, A.L.J., as successor to Heller, A.L.J.-- Taxpayer's business records were audited for the period from January 1, 1985 to June 30, 1989. As a result, a post-audit adjustment to the assessment was issued [in April 1990] in the final amount of $ . . . , which amount included interest.

In March 1982, Taxpayer merged with another bank (hereinafter termed "Bank X") under the provisions of Title 12 U.S.C. When the two banks merged, the assets and liabilities of both entities were combined onto the books of Taxpayer, which was the ongoing entity.

Section 215a of 12 U.S.C. provides that a national or state bank may merge with another national bank and continue its previously separate business under the charter of the surviving national bank. Section 215a does not prescribe the form or amount of consideration that must be paid to the merging banks or their shareholders. Because Bank X's liabilities exceeded its assets, Taxpayer paid no cash or other consideration to Bank X or its shareholders. Taxpayer did assume all the liabilities of Bank X, however, which is required by Section 215a(a)(4), and is inherent in any merger transaction. Because Bank X was formerly a mutual savings bank and its depositors were by law its shareholders, the depositors' status as shareholders was extinguished by the merger. The value of the merger to Bank X's shareholders was that their deposits (i.e., their claims on the bank as depositors and shareholders) would enjoy enhanced security through the merged entity's promise to pay those claims, as well as all other liabilities.

Taxpayer obtained letter rulings from the IRS that the merger qualified as a reorganization under Sections 368(a)(1)(G) and 368(a)(3)(D) of the Internal Code. For purposes of calculating gains or losses subject to federal income tax, Taxpayer used Bank X's historical cost.

In bringing Bank X's assets onto the books of the surviving bank, the accounting conventions of GAAP (generally accepted accounting principles) required that the assets be assigned a value. Two general approaches were available: "purchase accounting" and "pooling-of-interests accounting." Because Bank X's shareholders were not to have an ownership interest in Taxpayer after the merger, GAAP required that the "purchase accounting" convention be used. With respect to the valuation of assets, "purchase accounting" required that Taxpayer assign the assets their current fair market value rather than their true historical cost.

The auditor assessed additional tax over and above that already reported by Taxpayer on gains purportedly received on the subsequent sale of GNMA pool securities and on the discount of ICL loans after the merger. In so doing, the audit staff used the "purchase accounting" values assigned at the time of the merger as the "acquisition price" or cost in measuring gains and discount received. Audit staff reasoned that, because the "purchase accounting" convention had been used, that Taxpayer had purchased these assets from Bank X.
Taxpayer notes that the Department did not attempt to assess retail sales tax or use tax against Taxpayer, or real estate excise tax against Bank X, with respect to the property acquired by the merger's surviving entity.

In addition, Taxpayer entered into dealer agreements with a number of (primarily) automobile dealers. Pursuant to these agreements, Taxpayer would purchase "dealer paper" (i.e., loans) from a dealer. The following pertinent provisions were agreed to in these transactions (extracted from the non-recourse dealer agreement):

1. The dealer would warrant to Taxpayer that the contracts being purchased met certain specifications as to quality.

2. The dealer would assign the contracts to Taxpayer without recourse, except for the warranties made by the dealer to Taxpayer (in which case the dealer would repurchase the contract).

3. When a contract was purchased by Taxpayer, the dealer would thereafter waive all notice of any non-payment, delinquency, default, extension, demand or protest, and would consent to any extensions of time for payment Taxpayer might authorize to the buyer.

4. Key to this appeal, Taxpayer required the creation of a "Dealer's Reserve Account." To this end, one-half of the difference between the "contract rate" (the interest rate paid by the buyer to Taxpayer) and the "buy rate" (the interest rate to be retained by Taxpayer pursuant to its agreement with the dealer) would be deposited to this account. The Dealer's Reserve Account secured payment of "all indebtedness and performance of all obligations of the Dealer to the Bank. . . . " This reserve amount would be repaid to the bank if the contract was paid off within 90 days. Once all obligations between the parties were satisfied, the amount retained in the Reserve Account would be paid over to the dealer.

For example: A dealer would finance the sale of an automobile to a buyer at an interest rate (i.e., "contract rate") of 14%. Taxpayer would agree to purchase the contract (i.e., the "paper") from the dealer at a "buy rate" of 12%. The contract, which was warranted under the agreement between the dealer and Taxpayer to meet certain criteria, would be transferred, nonrecourse, to Taxpayer. Taxpayer would immediately deposit one-half of the 2% interest differential to the "dealer's reserve account." Taxpayer, in exchange for its promise to pay over to the dealer the principal amount of the loan and the 2% interest differential, would then collect the agreed upon principal and 14% contract interest from the buyer. The first half of the 2% differential would be paid immediately into the dealer's reserve account; the other one-half of the 2% differential would presumably be paid to the dealer as received (the amended agreement does not address this point specifically).

TAXPAYER'S EXCEPTIONS:

1. <u>Audit Schedule X ("Gain on Sale of GNMA Pool") ($ . . .)</u> and <u>Audit Schedule XI ("Discount Earned - ICL")</u> <u>($ . . .)</u>. Whether the use of "purchase method" accounting required by GAAP to be used at the time of a bank merger establishes a new "cost" upon which gain or loss must be calculated on the subsequent sale of investments for business and occupation tax purposes.

Taxpayer argues that the assessment of additional tax on gains and discount purportedly received by Taxpayer is based on an accounting fiction. Taxpayer reasons that the assessment can stand only if Taxpayer, as a matter of law, actually purchased the assets in question from Bank X, or the Department, based upon the consideration given by Taxpayer for the merger (its assumption of all of Bank X's known and unknown liabilities), had the statutory authority to assign a purchase price to each of Bank X's former assets equal to their fair market value at the time of the merger. Taxpayer argues that neither proposition holds up and that, therefore, the assessment must be cancelled.

In the case of the GNMA pool securities, Taxpayer argues that "it is clear that the measure of tax is the 'amount received from the sale of . . . [the] securities over and above the cost or purchase price of such . . . securities." WAC 458-20-162, and that this measure of tax was paraphrased by the Department in an unpublished 1983 Final Determination as follows:

> [T]he use of the term "gains realized" in reference to trading in securities makes it clear that, for these kinds of transactions, the taxable measure is to be determined at the completion of the securities

> exchange, based upon the exchange price less the acquisition price.

(Emphasis added.)

According to Taxpayer, then, the calculation of gain refers to the price received and the price paid. That is, Taxpayer must use an actual and initial purchase transaction, in which a purchase price was expressed, in order to calculate its gains. Changes in the value of securities while held by a taxpayer, whether up or down, do not affect the measure of gain.

Therefore, only the purchase price and the sales price determine the "gains realized from trading in stocks, bonds, or other evidence of indebtedness." RCW 82.04.080 (emphasis added). If a corporate reorganization does not constitute "trading" in securities, obviously it cannot give rise to a purchase price for use in calculating the gain. The merger of Taxpayer and Bank X did not entail a purchase of the securities, and therefore did not result in a "purchase price." The revaluation of the securities incident to the merger is therefore irrelevant to the calculation of Taxpayer's gain.

Taxpayer further argues that the auditor's characterization of the merger as an asset purchase ignored federal and state law, and that the Department and courts do not and cannot recharacterize the substantive legal nature of business transactions as established by the parties. See, e.g., Estep v. King County, 66 Wn.2d 76 (1965); Ban-Mac, Inc. v. King County, 69 Wn.2d 49 (1966) (per curiam). The Department has expressly recognized this limitation on its authority in, for example, Det. No. 87-212, 3 WTD 259, 268 (1987). Thus, neither the Department nor the courts can recharacterize a merger that has been accomplished in conformity with applicable law as a purchase of assets of the merging entity.

Section 215a(e) of 12 USC provides, in part, as follows:

> The corporate existence of each of the merging banks or banking associations participating in such merger shall be merged into and continued in the receiving association and such receiving association shall be deemed to be the same corporation as each bank or banking association participating in the merger. All rights, franchises, and interests of the individual merging banks or banking associations in and to every type of property (real, personal, and mixed) and chooses in action shall be transferred to and vested in the receiving association by virtue of such merger without any deed or other transfer.

The United States Supreme Court has held, in a case arising in this state, that this statute provides for the transfer of assets "wholly by operation of law" and not by purchase and sale. See United States v. Seattle-First National Bank, 321 U.S. 583, 588-89, 88 L. Ed. 994, 948, 64 S. Ct. 713 (1944). The court held that transfers of realty through the merger did not amount to a sale:

> There was a complete absence of any formal instruments or writings upon which the stamp tax is laid. Nor can the realty be said to have been "sold" or vested in a "purchaser or purchasers" within the ordinary meanings of those terms. Only by straining the realities of the statutory consolidation process can respondent be said to have "bought" or "purchased" the real property. That we are unable to do.

Id. at 590, 88 L. Ed. at 949.

Taxpayer submits that, even if the merger transaction resulted in a "transfer" of securities, loans, and other assets from Bank X to Taxpayer, the merger did not effect a "sale." The asset transfers were a mere incident to the real transaction of the statutory merger process. Therefore, as recognized in Rule 106, the merger was not relevant to the calculation of gains realized from trading in these securities - either for Taxpayer or for Bank X.

In conclusion, Taxpayer argues that the mere fact that an asset having a certain value may have passed from one party to another does not mean that the transfer occurred in a taxable form. The conventions of GAAP, which are designed to reflect the financial worth or health of a business entity, are not necessarily controlling in the context of a gross receipts tax. This case is an instance where, in a complicated mesh of statutory and accounting issues, the Audit Section has erroneously focused on the conventions of accounting rather than the legal nature of the transaction.

Therefore, the tax on Taxpayer's gains and discount must respect the usual consequences of a statutory merger. The assets were not in fact "sold" by Bank X to Taxpayer, and the surviving bank was a continuation of both predecessors and held the assets and attributes of both predecessors continuously by operation of law. Because no purchase transaction was incident to the merger, the purchase price paid by the merging entity continued as an attribute of Taxpayer after the merger.

2. Schedule XIII - Dealer Reserve Offsets ($125,453). Whether the interest differential collected from a buyer and paid into a

Dealer's Reserve Account and eventually to the dealer on a loan purchased by Taxpayer is a pass-through of interest earned by the dealer, or whether it is interest earned by Taxpayer and paid over to the dealer as part of the purchase price of the loan.

Taxpayer argues that the dealer - not Taxpayer - should be taxable on the interest differential because the dealer has "retain[ed] an undivided interest in the particular contracts payable."

DISCUSSION:

Issue #1: The Department has specifically recognized in WAC 458-20-106 ("Rule 106) that a number of transactions involving corporations do not constitute asset purchases. This rule stems from the recognition that the transactions so enumerated do "not constitute a 'sale' within the meaning of RCW 82.04.040." Det. No. 87-212, 3 WTD 259, 264 (1987).

Among the examples of nontaxable asset transfers cited in Rule 106 are transfers "pursuant to a reorganization under 26 USC Section 368 of the Internal Revenue Code, when capital gain or ordinary income is not realized."

In this case, Taxpayer and Bank X obtained a ruling from the IRS that the merger was qualified as a merger reorganization under Sections 368(a)(3)(D) and 368(a)(1)(G) of the Internal Revenue Code. Therefore, the merger transaction itself was not taxable to Bank X, because no "sale" of its assets occurred. Since Rule 106 provides that Bank X did not "sell" its securities to Taxpayer as a result of the merger, then Taxpayer cannot be said to have "purchased" them at that time.
[1] Accordingly, when these assets are sold, true historical cost (less any return of capital) will be used in the calculation of gain or loss for Washington excise tax purposes. Even though GAAP might require a substituted basis for assets acquired in merger, this does not result in a taxable sales event for B&O tax purposes.

Taxpayer's petition as to this issue is granted.

Issue #2:

[2] If an element of interest is retained by or paid over to the seller of a loan as a result of the contract of sale between the old and new owner - even though no portion of the loan has been retained by the old owner - that interest is a premium properly taxable to the seller of the loan as a gain. The new owner is taxable - absent a deduction - on that portion of the interest

paid over to the seller of the loan. See Det. No. 90-141, 9 WTD 280 (1990).

In this case, when Taxpayer purchased a dealer contract, it purchased the contract in its entirety. As such, Taxpayer was entitled to collect the full contract interest rate from the buyer without recourse to the seller. Taxpayer's agreement to pay over a portion of the contract interest rate to the dealer was negotiated as part of the selling price between the two parties. As such, the full contract interest received by Taxpayer was taxable as interest. That portion of interest paid over to the dealer was taxable as gain on the sale of its contract.

Taxpayer was properly taxable on the full amount of contract interest it received under the dealer contracts it purchased. This amount includes those portions of interest paid over to the dealers. Taxpayer's petition as to this issue is denied.

DECISION AND DISPOSITION:

Taxpayer's petition is granted in part and denied in part.

The Audit Section will eliminate the assessments in Schedules X and XI pertaining to "Gain on Sale of GNMA Pool" and "Discount Earned - ICL."

DATED this 7th day of December 1992.