

Cite as Det. No. 94-092, 14 WTD 251 (1995).

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

In the Matter of the Petition	)	<u>D E T E R M I N A T I O N</u>
For Correction of Assessment of	)	
	)	No. 94-092
	)	
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .
	)	

- [1] RCW 82.04.080, RCW 19.146.050: GROSS INCOME OF BUSINESS -- TRUST ACCOUNTS OF MORTGAGE BROKERS. The gross income of business does not include specific amounts which a mortgage broker receives from a borrower to pay third-party costs and which RCW 19.146.050 prohibits the taxpayer from commingling with its operating funds.
- [2] RCW 82.04.080: GROSS INCOME OF THE BUSINESS -- "DOCUMENT PREPARATION" FEES, "CORRESPONDENT" FEES, ACCRUED INTEREST, AND GAIN ON SALE OF LOANS. Gross income of the business includes amounts received by a mortgage broker for document preparation fees, correspondent fees, accrued interest, and gain on the sale of loans because they are received in the taxpayer's own right.
- [3] RCW 82.04.4292: B&O TAX -- DEDUCTION -- MORTGAGE INTEREST -- REQUIREMENTS. The RCW 82.04.4292 deduction 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.
- [4] RCW 82.04.080, 82.04.4292: GAIN ON SALE OF LOAN. When the taxpayer sells a loan to a third-party, the gain realized on that sale is fully taxable. The gain is not entitled to the deduction under RCW 82.04.4292.

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.

#### NATURE OF ACTION:

A mortgage company protests assessment of service and other activities business and occupation tax on its net receipts derived from loaning residential mortgage money and immediately selling the loan to a third-party financial institution.<sup>1</sup>

#### FACTS:

Coffman, A.L.J. -- The taxpayer, a mortgage company, is in the business of making and immediately selling loans secured by residential real property. The taxpayer's books and records were reviewed by the Department of Revenue's (Department) Audit Division for the period January 1, 1989 through December 31, 1992. Although the taxpayer had reported no business activity for the audit period, the review of the taxpayer's records showed it had gross receipts of \$. . . . The business and occupation (B&O) tax at the rate for service and other activities was assessed on this amount. Additionally, the Audit Division determined that the taxpayer had failed to pay use tax on certain tangible personal property. The Department issued a tax assessment.

The taxpayer states that it is a mortgage lender and not a mortgage broker (as that term is usually used). However, the taxpayer admits that it is governed by the Mortgage Broker Practices Act (Chapter 19.146 RCW). The taxpayer makes loans to consumers that are secured by first mortgages or deeds of trust.<sup>2</sup> The real properties are always nontransient residential properties. The taxpayer does not charge any discount points or loan origination fees as such. Rather, the loans are issued at par.

The taxpayer receives from the borrower specific amounts for the purpose of paying for the appraisal, credit report, closing fees, title insurance, and recording fees. When these amounts are paid

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

<sup>2</sup> For the sake of convenience we will refer to mortgages and deeds of trust by the term "mortgage" unless the discussion requires that we make a distinction.

by the borrower, the taxpayer places them in a trust account as required by RCW 19.146.050. Additionally, the borrower will pay to the taxpayer a "Document Preparation Fee", a "Correspondent Fee", a tax service fee<sup>3</sup>, and any interim or accrued interest charges.

The loans are issued by the taxpayer to the extent of its line of credit with another financial institution. Thus, the taxpayer borrows the money to loan.

Two lending institutions have agreed to purchase the loans the taxpayer issues if certain requirements are met. All of the taxpayer's loans are sold to these lending institutions immediately upon closing. The taxpayer uses the proceeds from that sale to repay its line of credit. The agreements require the taxpayer to make certain warranties concerning the loans. If the warranties are broken or the loans do not meet the requirements established by the lending institutions, the taxpayer may be required to repurchase the loans.

The taxpayer determines the estimated amount it will receive from the sale of the loan and then calculates as estimated profit. The estimated profit is then shown on its "Good Faith Estimate of Closing Costs" as an amount to be paid outside of closing. This amount is not paid by the borrower.

#### ISSUES:

1. Are amounts received by the taxpayer for the purpose of paying third-party costs and which are required by Chapter 19.146 RCW to be placed in trust includable in the taxpayer's gross income of the business?
2. Is interim interest received by the taxpayer from the borrowers deductible under RCW 82.04.4292?
3. Is the taxpayer's gain on the sale of the loans deductible for business and occupation tax purposes under RCW 82.04.4292?

#### DISCUSSION:

The taxpayer is engaged in business activities in this state. RCW 82.04.220 states:

There is levied and shall be collected from every person a tax for the act or privilege of engaging in business

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<sup>3</sup> This is essentially an insurance policy to guarantee that property taxes have been paid.

activities. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.

The taxpayer mistakenly believed that it was not required to report any of its income on its Combined Excise Tax Returns. In fact, the taxpayer is required to report all of its income and then, if entitled, it may take deductions from that gross income.

1. GROSS INCOME OF THE BUSINESS.

The taxpayer's business activities are subject to the B&O tax under the classification of service and other activities. RCW 82.04.290.<sup>4</sup> During the period of the audit the tax was imposed at the rate of one and a half percent (1.5%) of the gross income of the business. The term "gross income of the business" is defined in RCW 82.04.080 and included:

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.

Trust Account Receipts.

Even as a lender, the taxpayer is subject to the provisions of the Mortgage Brokers Practices Act pursuant to RCW 19.146.010(2) which defines a "mortgage broker" as: "every person who for compensation or in the expectation of compensation either directly or indirectly makes, negotiates, or offers to make or negotiate a residential mortgage loan."

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<sup>4</sup> We note that RCW 82.04.290 was amended effective July 1, 1993. That amendment created three subclassifications under services and other activities. The taxpayer's activities appear to be within the provisions of RCW 82.04.290(2) which reads:

Upon every person engaging within this state in banking, loan, security, investment management, investment advisory, or other financial businesses; as to such persons, the amount of the tax with respect to such business shall be equal to the gross income of the business, multiplied by the rate of 1.70 percent.

RCW 19.146.050 states:

A mortgage broker shall deposit, prior to the end of the next business day, all moneys received from borrowers for third-party provider services in a trust account of a federally insured financial institution located in this state. The trust account shall be designated and maintained for the benefit of borrowers. Moneys maintained in the trust account shall be exempt from execution, attachment, or garnishment. A mortgage broker shall not in any way encumber the corpus of the trust account or commingle any other operating funds with the trust account. Withdrawals from the trust account shall be only for the payment of bona fide services rendered by a third-party provider or for refunds to borrowers. Any interest earned on the trust account shall be refunded or credited to the borrowers at closing. (Emphasis added.)

The term "third-party provider" is defined in RCW 19.146.010(5) as:

any person other than a mortgage broker or lender who provides goods or services to the mortgage broker in connection with the preparation of the borrower's loan and includes, but is not limited to, credit reporting agencies, title companies, appraisers, structural and pest inspectors, or escrow companies. (Emphasis added.)

[1] The amounts the taxpayer receives from the borrower which are required by RCW 19.146.050 to be held in trust never accrue to the benefit of the taxpayer. The taxpayer is not permitted to expend those funds for any purpose other than specific third-party costs or refunds to the borrowers. Any interest earned on those funds may only be used for the same purposes. The taxpayer's creditors may not reach the trust fund account(s). The taxpayer may not commingle those funds with its operating funds. As such the amounts which are deposited in the trust account for the benefit of the borrower are never received by the taxpayer in its own right. Therefore, they are not part of the gross income of the taxpayer's business. See: Det. No. 92-73, 12 WTD 131 (1992) where we held that funds placed in an escrow account were not gross receipts of the escrow agent.

#### Document Preparation and Correspondent Fees.

[2] The document preparation fee is received by the taxpayer directly for its services. It is not received for a "third-party provider service". It is received "for the rendition of services" and therefore is part of the taxpayer's gross income of the business.

The amounts denominated as "Correspondent Fee" are likewise includable in the taxpayer's gross income. The correspondent fee is charged by the buyer of the loans for its own independent review of the loan documents. The taxpayer charges the borrower for this cost. The purpose is to assure the buyer of the loans that all the documentation is proper and complete.

This fee is not for the benefit of the borrower, rather it is for the taxpayer's benefit. The taxpayer's business is the sale of mortgages. This is a cost which the taxpayer must incur as part of that business. The taxpayer's receipt of funds to pay this cost does not constitute an advance or reimbursement because the transaction fails to meet the basic definition.<sup>5</sup>

The "Correspondent Fee" does not constitute a third-party cost per RCW 19.146.010(5) because it is not incurred "in connection with the preparation of the borrower's loan". Rather, it is incurred in relation to the subsequent sale of the loan once it is made. Therefore, the taxpayer's receipt of this amount from the borrower is not a trust fund receipt.

#### Accrued Interest.

The taxpayer's receipt of accrued interest from the home buyer at the closing is included in the taxpayer's gross income. This is the interest that the accrues from the date the loan is funded until the actual date of closing. Clearly, this amount does not constitute an advance or reimbursement under Rule 111 or qualify for any other exclusion.

#### Gain on Sale of Loans.

<sup>5</sup> The definitions of an advance and a reimbursement are contained in WAC 458-20-111 (Rule 111) which states, 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.

Finally, "gross income of the business" includes only the amount of gain the taxpayer receives from the sale of the loans not the gross sale price. Det. No. 89-461, 11 WTD 21 (1989) and RCW 82.04.080.

In summary, the taxpayer must include in its gross income all of its receipts from the borrower except those amounts that are held in trust. Likewise, the taxpayer's gross income includes the gain received on the sale of the loans. The total gross income of the business must be reported on the taxpayer's combined excise tax returns, then the taxpayer may take any deductions which it is entitled.

2. RCW 82.04.4292 DEDUCTION.

The Washington Supreme Court has stated:

Before proceeding with a direct consideration of this issue . . . we pause to observe that we attach no particular significance to the characterization of the statutory exclusions as "deductions" rather than "exemptions" insofar as the rules of statutory construction applicable here are concerned. Both a tax "exemption," which does not amount to total immunity, and a "deduction" presuppose a taxable status and must be claimed by the taxpayer if he is to benefit from either. In connection with each, the burden of showing qualification for the tax benefit afforded likewise rests with the taxpayer. And, statutes which provide for either are, in the case of doubt or ambiguity, to be construed strictly, though fairly and in keeping with the ordinary meaning of their language, against the taxpayer.

Group Health Coop. of Puget Sound, Inc. v. State Tax Comm'n, 72 Wn.2d 422, 433 P.2d 201 (1967). "Taxation is the rule and exemption is the exception." Budget Rent-a-Car of Wash.-Ore., Inc. v. Department of Rev., 81 Wn.2d 171, 500 P.2d 764 (1972).

[3] The taxpayer claims that it is entitled to deduct a substantial portion of its gross income pursuant to the provisions of RCW 82.04.4292 which reads:

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.

This deduction is available to a taxpayer, if it can satisfy the five elements which are:

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.

Det. No. 93-86, 12 WTD 603 (1993).

#### Interim Interest.

Interim interest received by the taxpayer accrues prior to the date of closing. As such it is earned prior to the loan being secured by a first mortgage or deed of trust. Thus, the taxpayer is not entitled to the deduction under RCW 82.04.4292 for interim interest charges.

#### Gain on Sale of Loans.

[4] The taxpayer also receives a gain on the sale of the loans. This gain constitutes the major portion of the taxpayer's profit. The Department has reviewed the gain on sale of these loans several times. It is well established that the gain on the sale of the loans is not entitled to the deduction found in RCW 82.04.4292. In Det. 89-461 we said:

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.

If at the time of the sale of the loans, a portion of the proceeds represents earned but unpaid interest the deduction will be available for that amount. Det. No. 89-461. However, the taxpayer has stated that it immediately sells all of its loans. Therefore, for business and occupation tax purposes, the gain the taxpayer receives from the buyer of the loan does not include any accrued, but unpaid, interest. Thus, the entire gain from the sale of the loan is fully taxable.

DECISION AND DISPOSITION:

Taxpayer's petition is granted in part and denied in part. The taxpayer's receipt of moneys from borrowers to pay third-party costs which are placed in the taxpayer's trust account pursuant to RCW 19.146.050, are excluded from gross income of the business. The taxpayer is also entitled to a deduction under RCW 82.04.4292 for interim interest and interest earned prior to the sale of the mortgage loan. All the other income of the taxpayer is subject to the business and occupation tax under the classification of service and other activities. The tax assessment will be remanded to the Audit Division for adjustment and a new assessment will be issued in accordance with the decisions rendered and will be due for payment by the due date stated thereon.

DATED this 6th day of May, 1994.