

Cite as Det. No. 06-0098, 26 WTD 260 (2007)

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition For Refund of	)	<u>D E T E R M I N A T I O N</u>
	)	
	)	No. 06-0098
	)	
...	)	Registration No. . . .
	)	Document No. . . .
	)	Docket No. . . .

RULE 146; RCW 82.04.080: FINANCIAL INSTITUTIONS -- GROSS INCOME -- LOSSES ON LOANS. The gross income of a financial institution is to be determined “without any deduction on account of losses.” Accordingly, because there is no statutory authority or controlling precedent that provides for a deduction for principal losses on impaired collateralized loans, the taxpayer is not entitled to a deduction for these losses.

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.

Breen, A.L.J. – A financial institution requests a refund of business and occupation (B&O) tax paid in relation to its investment activities contending it pays B&O tax on gains, thus it should be able to take a deduction for losses on unpaid principal amounts. We deny the taxpayer’s petition for refund.<sup>1</sup>

ISSUE

Whether the Revenue Act provides a deduction from the B&O tax for principal losses on impaired collateralized loans.

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

## FINDINGS OF FACT

[Taxpayer] is a Washington State-chartered commercial bank headquartered in . . . Washington. . . . The taxpayer conducts its business from . . . full-service offices located throughout Washington, [and in other states]. The taxpayer provides full-service banking, including FDIC-insured deposits and consumer and business banking, commercial real estate, and residential construction loans.

The taxpayer's primary sources of funds are investing and financing activities, including the collection of loan principal and interest payments. Financing activities consist primarily of customer deposits, advances from . . . , and other borrowings. The taxpayer also borrows funds under reverse repurchase agreements pursuant to which it sells investments, generally U.S. agency securities and mortgage backed securities (MBS), under an agreement to buy them back at a specified price at a later date. These agreements to repurchase are deemed to be borrowings collateralized by the investments and MBS sold. The taxpayer uses these borrowings to supplement deposits for funding the origination of various types of loans (residential mortgage loans, car loans, personal loans, etc.).

The taxpayer recognizes loan interest income by methods that conform to general accounting practices within the banking industry. The results of the taxpayer's loan operations are affected by changes in prevailing economic conditions, including rapid changes in interest rates, declines in real estate market values and the monetary and fiscal policies of the federal government. In the event the taxpayer's management believes collection of all or a portion of contractual interest on a loan has become doubtful, which generally occurs after the loan is . . . days past due, the taxpayer discontinues the accrual of interest and any previously accrued interest recognized in income deemed uncollectible is reversed. Interest received on nonperforming loans is included in income only if principal recovery is reasonably assured. Real property and other assets acquired through foreclosure of defaulted mortgage or other collateralized loans are carried at the lower of cost or fair value, less estimated costs to sell. An allowance for losses on real estate and other assets acquired through foreclosure is designed to include amounts for estimated losses as a result of impairment in value of the property after repossession.

DOR's Audit Division (Audit) performed a partial audit of the taxpayer's business records for the period January 1, 1999 through December 31, 2001. During the examination process, the taxpayer raised a number of arguments that would result in a reduction of tax liability or a refund. Many of these theories did not directly pertain to the assessment and/or examination process per se, but, instead, addressed the taxpayer's overall reporting methodology. Audit resolved the majority of these reporting issues. In calculating the taxpayer's taxable receipts, Audit allowed a number of credits and deductions, including a credit for "loan discount amortization" (discounting loans to market value), a deduction for interest income from loans secured by first mortgages on non-transient residential properties, bad debt deductions for previously accrued but uncollected interest, and a deduction for losses on the sale of various

assets. In spite of the additional credits and deductions provided to the taxpayer, an assessment for additional tax ensued. The taxpayer paid the assessment in full.

The taxpayer then requested from Audit a refund for alleged overpayments of B&O tax for the full statutorily permissible period based on the contention that when it incurs a loss resulting from an incomplete collection of a loan obligation or the sale of a loan at a loss (loan impairments), it should be able to offset current principal losses on collateralized loans against current taxable gains. . . . Audit rejected the taxpayer's underlying basis for the refund request. Audit reasoned that it was not aware of any allowable deduction for losses incurred for the value of unpaid loan principal and that no deduction should be allowed on a principal loss related to a particular asset when no B&O tax had been reported or paid in relation to principal gains related to that asset (such as real estate loan principal). The taxpayer now appeals Audit's denial.

### ANALYSIS

The business and occupation (B&O) tax is imposed for the privilege of engaging in business in Washington. RCW 82.04.220. The term "business" includes "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or another person or class, directly or indirectly." RCW 82.04.140. The measure of the tax is the gross proceeds of sales, value proceeding or accruing, or gross income of the business. RCW 82.04.220. In the present case, the germane issue is determining the taxpayer's "gross income of the business" in respect to its dealings in loans.

RCW 82.04.080 defines "gross income of the business," in pertinent part, as:

[T]he 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 added.)

Thus, when a person engages in "trading in stocks, bonds, or other evidences of indebtedness" only the "gains realized" are included in the person's taxable base for purposes of the B&O tax. This exception from the general presumption in the Revenue Act to tax all of a person's gross receipts appears to represent the Legislature's recognition that in some instances the mere return of capital outlays should not be included in a person's gross receipts tax base. However, as the statute makes clear, this legislative recognition does not stand for the proposition that one may deduct losses on a capital outlay ("without any deduction on account of losses").

This reading of the statute is buttressed by DOR's regulation interpreting the application of this statutory section to financial businesses. The taxability of business activities engaged in by

financial institutions is primarily addressed in WAC 458-20-146 (Rule 146). The rule, in part, provides:

Generally, the gross income from engaging in financial businesses is subject to the business and occupation tax under the classification service and other activities....

The term "gross income" is defined in the law as follows:

"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, 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.

The law allows certain deductions from gross income to arrive at the taxable amount (the amount upon which the business and occupation tax is computed). Deductible gross income should be included in the gross amount reported and should then be shown as a deduction and explained on the deduction schedules provided on the reverse side of the reporting form. The deductions generally applicable to financial businesses include the following:

...

(2) Interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties. (See WAC 458-20-166 for definition of "transient.") (RCW 82.04.4291.)

...

(4) Gross proceeds from sales or rentals of real estate (RCW 82.04.390). These amounts may be entirely excluded from the gross income reported and need not be shown on the return as a deduction. (Emphasis added.)

In the present case, Audit provided the above allowable deductions and also allowed credits/deductions for income accrued by the taxpayer but not received pursuant to WAC 458-20-196 (Bad Debts). Nevertheless, the taxpayer contends that it overpaid its tax liabilities and requests the refund at issue in this case.

The taxpayer's refund request is based on a proffered entitlement to a deduction for principal losses on impaired loan collections. Yet, Rule 146 reiterates the language in RCW 82.04.080 and plainly states that the taxpayer's gross income is to be determined "without any deduction on account of losses." *See also* WAC 458-20-14601 (Rule 14601) (3)(k). . . .

Because we are not aware of any statutory authority or controlling precedent that provides for a deduction for principal losses on impaired collateralized loans, we must deny the taxpayer's petition. DOR, as an administrative agency, has no authority to grant an exemption or deduction

where none exists in the law. Only the Legislature, through enactment of appropriate legislation, may do so. See *Budget Rent A Car v. State*, 81 Wn. 2d 171, 500 P.2d 764 (1972); Det. No. 87-42, 2 WTD 201 (1986); Det. No. 87-169, 3 WTD 145 (1987); Det. No. 90-202, 9 WTD 286-85 (1990); Det. No. 04-0006, 23 WTD 195 (2004); Det. No. 04-0287E, 24 WTD 275 (2005).

#### DECISION AND DISPOSITION

The taxpayer's petition for refund is denied

Dated this 15th day of May 2006.