

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. 89-280
)
)
 . . .) Registration No. . . .
) . . . /Audit No. . . .
)

[1] RCW 82.04.4292: B&O TAX -- DEDUCTION -- INTEREST ON LOANS SECURED BY 1ST MORTGAGE OR DEED OF TRUST -- ORIGINATION FEES. Loan origination fees which relate to loans primarily secured by first mortgages or deeds of trust on nontransient residential property, and which are based on a percentage of the principal amount and represent an interest yield adjustment charged on loans are deductible under RCW 82.04.4292. Loan fees which represent charges for set-up fees or other services are subject to Service B&O. Accord: Det. 88-255, ___ WTD ___ (1989).

[2] RCW 82.04.4292: B&O TAX -- DEDUCTION -- INTEREST ON LOANS SECURED BY 1ST MORTGAGE OR DEED OF TRUST -- COMMITMENT FEES. Nonrefundable loan commitment fees paid by a prospective borrower to hold the terms of a loan for a stated period of time are not compensation for the use of money and, therefore, not deductible 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.

TAXPAYER REPRESENTED BY: . . .

DATE OF HEARING: October 18, 1988

NATURE OF ACTION:

A mortgage corporation protests the assessment of service B&O on loan fees which it contends represent an adjustment to yield rather than fees for services.

FACTS AND ISSUES:

Roys, A.L.J. -- The taxpayer's records were examined for the period January 1, 1983 through December 31, 1986. The audit disclosed taxes and interest owing in the amount of \$ Document No. . . . in that amount was issued on August 27, 1987.

The auditor assessed Service B&O on unreported origination and commitment loan fee and brokerage fee income. The tax was assessed on unreported fee income received December 1986. (. . .). Prior to that date the taxpayer reported the fee income. The taxpayer protests the assessment, contending the fees represent deductible interest. In addition to protesting the present assessment, the taxpayer seeks a refund or credit for taxes previously paid on loan fees.

At the hearing, the taxpayer's representative stated that the taxpayer employs producers who find borrowers and initiate loans. The producers prepare forms which are provided to the taxpayer's loan committee which approves or disapproves the loan application. The representative stated that the producers used the terms loan fees, commitment fees, points, and broker's fees interchangeably, and that all are charges for the use and forbearance of money. Costs incurred during the loan processing and application are charged to the borrower in addition to the fees or points.

Until December of 1986, the taxpayer had reported and paid B&O on all of its loan fees. The auditor informed the taxpayer that "points" collected on loans primarily secured by first mortgages on nontransient residential properties could be treated as an adjustment to yield and deducted from the measure of the tax. According to the taxpayer, the auditor stated the Department has not treated loan fees as deductible points.

The taxpayer stated it lumped loan fees, points, and brokers' fees together in its general ledger. All were computed the same way and treated the same way in accordance with generally accepted accounting principles. The taxpayer stated that the auditor looked at the actual loan documents. If the documents stated a charge for "points" a deduction was allowed, if the points were charged on a loan primarily secured by first mortgages on nontransient residential properties. If the

document said the charge was for a loan fee or a brokers fee, the deduction was not allowed.

The taxpayer contends that the term used on the document should not control. The taxpayer contends any fees it charges on loans are points and represent an adjustment to yield rather than a fee for services.

The auditor also assessed use tax and/or deferred sales tax on purchases of capital assets and consumable items on which no tax had been paid. (. . .). The taxpayer does not protest this part of the assessment.

DISCUSSION:

[1] Loan Origination Fees and Broker's Fees -- Amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties are exempt from the B&O tax. RCW 82.04.4292. The primary issue raised in this appeal is whether amounts designated "loan origination fees" and "broker's fees" are charges for interest and should be entitled to the deduction provided by RCW 82.04.4292, or whether the fees are in part charges for services and therefore subject to Service B&O tax.

The term "interest" is not defined in the Revenue Act. A common definition of interest is that it is a charge for the use or forbearance of money, generally expressed as a percentage of the principal amount. In previous decisions, the Department has taken the view that no matter what designation is used, amounts received as compensation for the use of money, or for forbearance in demanding it when due, constitute interest. Discount points, for example, have been held to constitute "interest." This decision is in accordance with the treatment of points as interest for federal tax purposes. See IRC § 461 (g)(2) and Revenue Ruling 69-188, 1969-1 C.B. 54.

On the other hand, a loan origination fee charged by a lender to prepare loan documents, make credit checks, etc., represents consideration for the rendition of services incident to the creation of a mortgage rather than an amount for the use of money. Consequently, such loan fees do not constitute deductible interest.

In City Mortgage Services, Inc. v. State of Washington, Dept. of Revenue, Docket No. 83-2-01420-1, Thurston County Superior

Ct. (1986), the Court held that a mortgage company was not entitled to a refund of B&O tax paid on loan origination fee receipts. The Court relied in part on the following definitions in the HUD 1 Uniform Settlement Statement:

801. Loan Origination. This fee covers the lender's administrative costs in processing the loan. Often expressed as a percentage of the loan, the fee will vary among lenders and from locality to locality. Generally the buyer pays the fee unless another arrangement has been made with the seller and written into the sales contract.

802. Loan Discount. Often called "points," a loan discount is a one-time charge used to adjust the yield on the loan to what market conditions demand. It is used to offset constraints placed on the yield by state or federal regulations. Each "point" is equal to one percent of the mortgage amount. . . .

In Aetna Finance Co. v. Darwin, 38 Wn.App 921 (1984), the court found Aetna's loan funding fees were setup charges normally incidental to making a loan which must be treated as interest for usury purposes.¹ The court stated:

Charges for making a loan and for the use of money are interest; charges are not interest if they are for services actually provided by the lender, reasonably worth the price charged, and for which the borrower agreed to pay.

38 Wn. App. at 926 (citation omitted).

In the present case, the taxpayer contends that the "loan origination fees" and the "broker's fees" at issue are charges based on a percentage of the principal loan amount and adjust the yield on the loan. The taxpayer contends the fees are not for services provided by the taxpayer.

The taxpayer's records indicated that a portion of the loan fees was recognized as income in the year the loan was made and a portion was deferred and amortized. The Financial Accounting Standards Board (FASB) Statement No. 91, issued

¹Under RCW 19.52.020, a setup charge is exempt from characterization as interest only if it is made in connection with a loan of \$500 or less.

December 1986, provides that loan origination fees and related direct loan origination costs for a given loan shall be offset and only the net amount shall be deferred and amortized. (Part 5, at p.2) Direct loan origination costs are described as follows:

(a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.

The Department is not taking the position that under the City Mortgage case referred to above, the total amount of charges labeled "loan fees" represents charges for services and no portion is deductible interest. Instead, the Department will consider the substance of the charges, but the taxpayer has the burden of proof to show that the charges represent interest and not charges for services. This burden is not met if the charges are for services, as underwriting or direct loan origination costs, and are recognized as income on the taxpayer's books. In the present case, therefore, if part of the fees were recognized as income as direct costs of loan origination, such amounts do not constitute deductible interest.

In a previous Determination, Det. 88-255, ___WTD___(1989), we found that a savings and loan association's charges for "loan fees" constituted interest. In that case, the association stated that the loan fees were based on a percentage of the principal loan amount and adjusted the yield on the loan. The association testified that the loan fees had nothing to do with any services provided by the lender; services were separately stated and charged to the borrower.

That savings and loan association relied in part on a federal tax case, Pacific First Federal Savings & Loan Association v. Commissioner, 79 T.C. 512 (1982), in which the court held loan origination fees charged in connection with loans were interest and not charges for services. Pacific First Federal Savings & Loan (PFF) designated the loan fee as a prepaid finance charge on its Federal Truth in Lending statements and added the fee to the interest rate in determining the annual percentage rate. The fee was treated as interest for purposes of determining compliance with State usury laws. PFF had accounted for its loan fees for federal income tax purposes on a deferred basis over the life of the loan, as it had accounted for stated interest. PFF also had reported the loan fees as exempt interest for B&O tax purposes. The Court noted that the Department had not challenged that treatment. 79 T.C. at 515.

The IRS argued that a portion of the loan fees was allocable to services, rather than an interest charge, and that amount should be reported in the year received rather than over the life of the loan. The Tax Court disagreed, holding that the loan fees were additional interest income.

The Court noted that whether a particular payment constitutes interest is determined by the facts, not by the terminology used and that the taxpayer had the burden of proof to show the fees were interest. The Court concluded that the following facts supported a finding that the loan fees were for additional interest rather than services:

(1) The loan fee rate was dependent upon the same factors relied on in determining the interest rate, namely the degree of risk involved and the current money market. The loan fee rate and interest rate were negotiable and were mutually dependent;

(2) No relationship existed between the cost in underwriting a loan and the loan fee charged thereon. This fact was supported by the fact that the loan fee was simply calculated as a percentage of the principal amount of the loan and no loan fee was charged if a loan did not close. Also, all of the third party costs incurred by PFF on a loan were charged to and paid by the borrower in addition to the loan fee, with the exception of escrow and appraisal services which were provided free of charge;

(3) PFF consistently treated the loan fee as interest for purpose of complying with Federal Truth in Lending requirements and state usury and tax laws.

In conclusion, Service B&O is due on the portion of the taxpayer's loan fees which were direct loan origination costs and were treated on the taxpayer's books as income.

Similarly, if brokerage fees are charges for services performed in assisting the creation of a transaction, the fees are not compensation for the use of money. As the audit instructions stated, "income received for bringing a lender and a borrower together cannot be considered interest."

If, however, amounts stated as brokerage fees were no different than the amounts which were designated as points or loan origination fees, we agree that the substance of the fee rather than the label should control. If the taxpayer's records support its statement that all three were treated the same on its books, and the only difference was the term used by the producers on the documents provided to the loan committee, all three will be treated the same. The portion of the fees that related to direct loan costs is subject to Service B&O; the portion that was deferred and amortized will be treated as interest if the fees otherwise meet the above criteria stated by the court in the PFF case.

[2] Commitment fees. The taxpayer's records indicated it charges a nonrefundable commitment fee which is due on acceptance of a loan commitment. (. . .) The auditor's instructions stated that commitment fees are viewed as consideration for an agreement to lend money in the future at specified terms, and not compensation for the use of money, or for forbearance in demanding it when due.

We agree with the auditor's conclusion. The loan commitment fee is incurred by the prospective borrower before any money is loaned and is due whether or not an actual loan follows. A nonrefundable fee paid by a prospective borrower to hold the terms of a loan for a stated period of time is not compensation for the use of money.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part. The assessment is sustained on loan commitment fees. . . .

DATED this 24th day of May 1989.

DETERMINATION (Cont)
No. 89-280

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Registration No. . . .