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

In the Matter of the Petition for Refund of	)	D E T E R M I N A T I O N
	)	No. 89-474
. . .	)	Registration No. . . .
	)	Tax Assessment No. . . .

[1] **RCW 82.04.4292 AND RULE 109 AND RULE 146:** B&O TAX - SALE OF LOANS SECURED BY FIRST MORTGAGES - "PREMIUM" - INTEREST V. TRADING GAIN - CHARACTERIZATION BY PURCHASER AS "CONTRA-INTEREST." The nature of taxpayer receipts is not governed by how the payor accounts for the expenditure, but is classified on its own merits with respect to the nature of the taxpayer's activities.

[2] RCW 82.04.4292 AND RULE 109 and RULE 146: B&O TAX - SALE OF LOANS SECURED BY FIRST MORTGAGES - "PREMIUM" - INTEREST V. TRADING GAIN - AMOUNTS DERIVED FROM INTEREST RECEIVED - CONSTRUCTION OF. A "premium" which the taxpayer receives from the purchaser of a mortgage loan in addition to payment for the face amount of the loan is in the nature of consideration, taxable as a trading gain, and is not deductible as an "amount derived from interest received" under RCW 82.04.4292.

[3] RCW 82.04.4292 AND RULE 109 AND RULE 146: B&O TAX - SALE OF LOANS SECURED BY FIRST MORTGAGES - "PREMIUM" - RETAINED INTEREST ELEMENT - AMOUNT DERIVED FROM INTEREST RECEIVED. When a loan is sold for the face amount of the loan and an additional "premium" based on the spread in interest rates, such "premium" is a

trading gain and cannot properly be considered the receipt of deductible interest.

[4] RULE 162: B&O TAX - GROSS INCOME OF BUSINESS - STOCKBROKERS AND SECURITY HOUSES - NETTING OF GAINS AND LOSSES WITHIN AN ACCOUNT - "SECURITY HOUSE" OR "STOCKBROKER" - APPLICABILITY OF RULE. Rule 162, which applies to "stockbrokers" and "security houses," applies equally to financial institutions such as banks which sell securities in the same manner as regular security houses.

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: January 6, 1986

NATURE OF ACTION

An excise tax audit of the taxpayer's books and records resulted in the assessment of business and occupation tax under the service classification on unreported gains on mortgage loans sold.

FACTS:

Bauer, A.L.J.-- The Department of Revenue examined the business records of the taxpayer (. . .) for the period January 1, 1981 to December 31, 1984. As a result of this audit, the Department issued the above-referenced tax assessment on July 30, 1985 assessing an excise tax liability in the total amount of $. . . . The taxpayer has paid the assessment in full, and seeks relief and refund of taxes paid on what the Department had concluded to be unreported gains on mortgage loans.

The taxpayer in its petition dated September 16, 1985 describes the taxpayer and its business activities as follows:

The Taxpayer is a Washington corporation engaging in the mortgage banking business. It is a wholly owned subsidiary of ..., a savings and loan association organized under the laws of the state of Washington (the "Parent").

During the audit period involved, the Taxpayer would originate loans secured by first mortgages or first trust deeds on nontransient residential properties ("Mortgage Loans"). As part of an integrated transaction, the Mortgage Loans in question were transferred to the Parent. The Parent would in turn sell a ninety-five percent participation in the principal of the Mortgage Loan to an independent third party such as the Federal Home Loan Mortgage Corporation ("Freddie Mac"), plus sell such amount of the interest portion of the Mortgage Loan to yield a calculated rate. The difference between the stated interest rate and the yield to buyer is referred to as the "spread." The spread could be positive resulting in a "premium" or negative resulting in a "discount." The spread is retained by the Parent and in turn by the Taxpayer in the nature of a premium or discount realized on the transfer to the Parent. Twenty-five basis points on the Mortgage Loan are assumed to represent the servicing costs of the Mortgage Loan.

The spread, if positive, less the 25 basis points representing the servicing costs, is recorded by the Taxpayer as a "premium receivable" from the Parent. Therefore, upon the transfer of the Mortgage Loan by the Taxpayer to the Parent, which results in a positive spread, the Taxpayer received cash equal to the face amount of the Mortgage Loan plus the retained "premium receivable."

At the hearing, the taxpayer elaborated on these transactions by explaining that the taxpayer sells the loans it has originated to its corporate parent for the loan's face value, and that no gain or loss is recognized to this extent. The taxpayer's corporate parent then sells those loans to "Freddie Mac" at an interest rate which may be less than the interest rate the taxpayer's borrower is obligated to pay, e.g., a 12% mortgage might be sold to Freddie Mac for 11 1/2%. The parent calculates and pays this positive interest differential, or "premium," to the taxpayer when the loan is transferred. Payment of the "premium" is not contingent on the original borrower's payment of interest.

TAXPAYER'S EXCEPTIONS:

The taxpayer's arguments are set forth in its petition as follows:

II. LAW AND ANALYSIS

A. Premiums Are Amounts Derived from Interest.

RCW 82.04.4292 regarding the B&O Tax states 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. [Emphasis supplied.]

The statute uses the term "amounts derived from interest"; it is therefore not limited to payments of interest, but is broader in scope. If the legislature had intended to limit the deduction to interest alone, it would have said so by using terminology such as "interest paid or accrued on" instead of employing the term "derived from."

A leading accounting text states with regard to premiums on debt instruments, in this case a bond:

> * * * similarly, if the bonds are priced to yield 6%, the premiums . . . represent[s] an advance paid by bondholders for the right to receive larger annual interest checks and should be viewed as a reduction in the effective interest expense. (The premium is in effect "returned" to bondholders periodically in the form of more generous interest payments). Meigs, Mosich, Johnson and Keller, Intermediate Accounting, 3d ed., p. 683 (1974).

A debt instrument which carries an interest rate in excess of the prevailing interest rates on similar debt instruments will yield a premium attributable to that higher interest rate. Likewise a debt instrument carrying an interest rate less than the prevailing market rate will sell at a discount. Premiums and discounts are a function of interest rates. Based on the foregoing, it is clear that a premium is an "amount derived from interest" within the meaning of RCW 82.04.4292, and deductible in

computing the B&O Tax involved herein since the Mortgage Loans are secured by first trust deeds or first mortgages on nontransient residential properties.

Other evidence that a premium is interest is that if one purchases a debt instrument at a premium, generally accepted accounting principles require that that premium be amortized over the life of the debt instrument as an offset to the interest income (i.e., a contra-revenue account). Likewise, if purchased at a discount the discount is amortized over the life of the debt instrument and taken into revenue. If a premium is a contra-interest revenue account to a purchaser, it must be interest revenue to the seller. Does the Department not intend to impose the B&O Tax on discount amortization? If the Department maintains that discount amortization is taxable, then consistency requires that premiums be considered interest also.

B. Premium Is a Retained Interest Element.

Another way to look at a premium on the Mortgage Loans is that a debt obligation is composed of two elements, the interest element and the principal element. Those elements can be divided or portions carved-out. If a Mortgage Loan holder sells the Mortgage Loan, he can sell all or part of the two elements composing the Mortgage Loan. By selling at a premium, he has retained a portion of the interest element, and hence the premium is a retained right to interest income. Since the Mortgage Loans are secured by first trust deeds or first mortgages on nontransient residential properties, the retained interest (the premiums) is deductible in computing the B&O Tax under RCW 82.04.4292, since the premium is retained interest and hence an "amount derived from interest."

C. Netting of Gains and Losses Under Rule 162.

Assuming the Department is correct regarding the characterization [of] the premiums as gains from the sale of secured notes, then WAC 458-20-162 applies, enabling the Taxpayer to net on a monthly basis its gains and losses from the sale of Mortgage Loans.

III. CONCLUSION

Premiums realized by the Taxpayer on which the Assessment has been made are not subject to B&O Tax since under RCW 82.04.4292 they are "amounts derived from interest" received on investments or loans primarily secured by first mortgages or first trust deeds on nontransient residential properties. This is so either because premiums are "amounts derived from interest" or are retained interest. Alternatively, if the premiums are gains from the sale of the Mortgage Notes, such gains are to be netted on a monthly basis against losses pursuant to WAC 458-20-162.

Post-hearing information received telephonically on March 31, 1987 confirmed that the taxpayer receives the "premium" from its parent "up front" when the loan is transferred. Payment of the "premium" is not contingent on the parent actually receiving full interest payments from the borrower.

Further, for accounting and tax purposes, the parent considers the gross amount of interest received minus the premium paid to the taxpayer (a contra-revenue account is set up for this amount) to be interest received. The RCW 82.04.4292 deduction, then, is limited by this net amount.

ISSUES:

The issues before us for resolution are as follows:

1. Whether the fact that a premium paid to the taxpayer for a debt instrument is accounted for in the purchaser's contra-interest revenue account necessarily renders that payment "interest" to the taxpayer.

2. Whether the premiums received on sales of participations in loans secured by first mortgages or trust deeds on nontransient residential properties are deductible under RCW 82.04.4292 because they are amounts which are "derived from interest."

3. Whether the premiums received on sales of participations in loans secured by first mortgages or trust deeds on nontransient residential properties are deductible under RCW

82.04.4292 under the theory that such premiums are retained portions of the interest element of those loans which have been sold.

4. Whether, assuming the above issues are answered in the negative, WAC 458-20-162 would enable the taxpayer to net its gains against losses from the sale of mortgage loans on a monthly basis.

DISCUSSION:

RCW 82.04.4292 provides the following interest deduction:

> 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.

Thus, if an amount is "derived from interest received," it is deductible by financial institutions. Our first inquiry, then, must be whether there has been "interest received." If so, our second inquiry will be whether the amount in question has been "derived from" such "interest received."

The Revenue Act of this State does not define the term "interest." The Supreme Court of Washington in Security Savings Society v. Spokane County, 111 Wash. 35 (1920) discussed a legislative change in the rate of interest applicable to delinquent taxes, and in so doing noted that,

> Interest is merely a charge for the use or forbearance[1] of money. In such case as this it has the character of both a penalty and an interest charge.

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[1] **FORBEARANCE.** Act by which creditor waits for payment of debt due him by debtor after it becomes due.... A delay in enforcing rights.... Indulgence granted to a debtor.... Refraining form action.... (Black's Law Dictionary 3d Edition 1968, citations omitted.)

The definition used by the Court in Security Savings is that uniformly applied in all states, the theory being that no matter what designation is used, amounts received as compensation for allowing the use of money or forbearing to collect it when due constitute "interest." Judicial statements from several other jurisdictions are representative of the uniformly applied concept of interest:

> "Interest" is a consideration for the use of money, or for forbearance in demanding it when due. Maryland Casualty Co. of Baltimore v. Omaha Electrical Light and Power Co., 157 F. 514.
>
> If financing charges are compensation for use, forbearance or detention of money, it is "interest." Associates investment Co. v. Thomas, Texas Civil Appeals, 210 S.W. 2d 413.
>
> No matter what the form of an agreement for extra payment on account of delay to perform an obligation to pay money, the extra payment is "interest." Gordon Finance co. v. Chambliss, La. App. 236 So. 2d 533.

On the other hand, "premium" is defined as follows:

> A bounty or bonus; a consideration given to invite a loan or a bargain; as the consideration paid to the assignor by the assignee of a lease, or to the transferrer by the transferee of shares of stock, etc. So stock is said to be "at a premium" when its market price exceeds its nominal or face value. Boston & M.R.R. v. U.S., C.C.A. Mass., 265 F. 578, 579. See Par.
> BLACK'S LAW DICTIONARY 1344 (Revised 4th Edition, 1968)
>
> The amount by which the price of a security or other asset exceeds its nominal, face, par, quoted, or market value.
> E. KOHLER, A DICTIONARY FOR ACCOUNTANTS 382 (3d Edition, Prentice-Hall, 1952)

While we agree with the taxpayer's argument that premiums and discounts are derived from the spread in interest rates, we do not think that this rationale can be extended so as to arrive

at the proposition that premiums are actually "amounts derived from interest received." To come to such a conclusion, we would have to determine that the retained premium is in reality a "charge for the use or forbearance of money" (i.e., "interest" to the taxpayer), and not merely consideration received by the taxpayer for the sale of its mortgage.

ETB 463.04.146 is currently the only published Departmental guidance which addresses the taxability of interest from participation loans:

Is interest collected by one financial institution for another to which it sold an undivided interest in a loan taxable to the former institution?

Restated, the question is: In a participating loan situation must the collecting institution pay business and occupation tax on that portion of the interest collected for the participating institution? For purposes of this excise tax bulletin, a participation loan is a loan or portion thereof sold by one financial institution to another.

The Department holds that in the situation described above, if the contract between the borrower and the lending institution authorizes the institution to sell or assign the loan, the institution acts merely as a conduit in collecting the assigned interest. Thus, the assigned interest is not income to the lending institution and is, therefore, taxable only to the assignee.

Although not dispositive of this case, the ETB is instructive in that those parties whose money is actually being used by the borrower (i.e., the party which owns the loan and the party who has purchased a participation) are required to report interest income only in proportion to their investment in the loan. It follows that if there is no longer an investment by a taxpayer, no interest should be reported, and thus no RCW 82.04.4292 deduction would apply.

In this case, the loan is transferred from the taxpayer to the parent in exchange for payment in the amount of the face value of the loan and the premium which will be received (minus the service charge retained by the parent) on the sale of a participation in the loan from the parent to Freddie Mac. The amount of premium to be actually received by the taxpayer is in no way dependent on the borrower continuing to pay the agreed upon interest; and we must note that interest might

not be ultimately paid due to either principal prepayment or default.

When a loan is transferred to the parent, the taxpayer receives a full return on its funds since the full face value of the loan has been received in exchange. The taxpayer no longer has an investment in the loan, and its money is thus not being used by the borrower. We would thus be hard pressed to hold that the additional premium received by the taxpayer is in the nature of interest, since the taxpayer's money is in fact not being used by the borrower.

The premium received by the taxpayer in this case is not an amount derived from "interest received" simply because the taxpayer receives a premium or a premium receivable. The premium in this case is not "interest," or compensation for "the use or forbearance" of the taxpayer's money, since the money originally lent by the taxpayer has already been fully recovered by virtue of the taxpayer's parent having purchased the loan in its entirety.
The parent has become the party entitled to receive the "interest" received on the loan. Likewise, by virtue its subsequent purchase of its participation in the loan from the parent, Freddie Mac then becomes the party required to report interest collected. The taxpayer's parent, as seller of the participation, receives and passes this interest on to the owner of the participation (Freddie Mac) tax free. ETB 463.04.146.

In Determination 89-461, __ WTD __ (1989) we held that amounts received by a seller for interest which had accrued prior to the sale of federalized mortgage-backed securities was an "amount derived from interest received." We reasoned that the taxpayer, prior to the sale, had "received" interest for tax purposes when it was accrued and entered into its books, and thus these entries were already "interest received." When an amount equal to the accrued interest was received from the buyer of the security, which would actually receive the interest, such then constituted an "amount derived from interest received."

Additionally, in the above cited determination, we held that a gain from the sale of a first mortgage was not an "amount derived from interest received," even though the calculation of the gain was uncontrovertedly based on the spread in interest factors, because no interest had in fact been received by the seller.

Similarly, the premium received by the taxpayer here at issue is not "for the use or forbearance of [its] money," since the taxpayer had already been fully reimbursed by its corporate parent for the face amount of the loan originally made to its borrower. Neither had any interest accrued prior to the transaction for which the premium served as a reimbursement. The taxpayer had neither received (by accrual or otherwise) any interest prior to the time of the sale, nor could it receive "interest" after it had sold the loan to its corporate parent since its money was not being used. Thus, the premium could not be an "amount derived from interest received" because, in fact, there had been no interest received.
The taxpayer has argued that because a premium paid for a debt instrument is accounted for by the purchaser in a contra-interest revenue account, then it must be interest to the seller. We do not find this argument persuasive.

[1] The fact that a premium paid for a debt instrument is accounted for in the purchaser's contra-interest revenue account does not necessarily render that payment interest to the taxpayer. The nature of a taxpayer's receipts cannot be governed by how the payor accounts for the expenditure, but must be classified on its own merits with respect to the nature of the taxpayer's activities.

[2] The premium receivable which the taxpayer receives from its corporate parent along with payment for the face amount of the loan is in the nature of consideration, and is thus taxable as a trading gain, not deductible as an "amount derived from interest received" under RCW 82.04.4292.

The taxpayer's right to receive the premium was not contingent on the borrower paying the interest due. Further, the premium payment was not a charge for the use or forbearance of the taxpayer's money. The fact that the amount of the premium was derived from and determined by the spread in interest rates on a subsequent sale of a participation did not necessarily render the payment to be an amount "derived from interest received."

Accordingly, we hold that the premium receivable which the taxpayer received from its corporate parent along with payment for the face amount of the loan was in the nature of consideration, and was thus taxable as a trading gain.

[3] As to the argument that the premium was a retained interest element, we must disagree for reasons similar to those stated above. First, the premium being received in conjunction with full payment of the face amount of the loan was not "interest received," i.e., payment for "the use or forbearance of money." Second, because payment of the premium was not contingent on interest actually being received from the borrower, it was not "derived from" interest and was thus a trading gain.

The taxpayer has lastly argued that if it is determined that the premiums are characterized as gains from the sale of secured notes, then WAC 458-20-162 (Rule 162) should apply, enabling the taxpayer to net on a monthly basis its gains and losses from the sale of mortgage loans.

Rule 162, in pertinent part, provides as follows:

> With respect to stockbrokers and security houses, "gross income of the business" means the total of gross income from interest, gross income from commissions, gross income from trading and gross income from all other sources: Provided, That:
>
> (1) Gross income from each account is to be computed separately and on a monthly basis;
>
> (2) Loss sustained upon any earnings account may not be deducted from or offset against gross income upon any other account, nor may a loss sustained upon any earnings account during any month be deducted from the gross income upon any account for any other month;
>
> (3) No deductions are allowed on account of salaries or commissions paid to employees or salesmen, rent, or any other overhead or operating expenses paid or incurred, or on account of losses other than under "2" above;
>
> (4) No deductions are allowed from commissions received from sales of securities which are delivered to buyers outside the state of Washington.

[4] The above rule, which applies to "stockbrokers" and "security houses," applies equally to financial institutions such as banks which buy and sell securities in the same manner

as regular security houses. Accordingly, the taxpayer will be permitted to monthly net its gains and losses in each of its securities earnings accounts.

DECISION AND DISPOSITION:

The taxpayer's petition for refund is granted in part. A refund or credit, plus statutory interest, will be issued after reexamination of the taxpayer's books in accordance with this determination.

DATED this 28th day of September 1989.