Cite as 8 WTD 379 (1989)

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. 89-489
. . .	Registration No. . . .
	. . . /Audit No. . . .

[1] RULE 146: SERVICE B&O TAX -- BANKS -- NEGOTIABLE INSTRUMENTS -- BANKERS' ACCEPTANCES -- TAXABLE INCOME. The taxable income on a bankers' acceptance is the difference between the face amount of the acceptance and the amount dispersed to the drawer. When the acceptance is rediscounted to an unrelated third party, the difference between the amount dispersed and the amount the bank receives for the acceptance from the third party is the proper measure for tax.

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 TELEPHONE CONFERENCE: June 27, 1989

NATURE OF ACTION:

Taxpayer petitions for refund of taxes assessed relating to certain "bankers' acceptances" and for waiver of penalty.

FACTS AND ISSUES:

Hesselholt, A.L.J. -- Taxpayer is a branch of an international bank based in the . . . . The [Washington] branch has been in operation since . . . . Its books and records were audited for the period January 1, 1984 through June 30, 1988. An assessment was issued in the amount of $ . . . , which has been paid. Taxpayer objects to that portion of the assessment in which the auditor denied deductions taken by the taxpayer for "interest expense from the interest income earned on Banker Acceptances . . . B & O tax is due on the gross income earned without deduction for any costs of doing business."

The taxpayer explained that generally the bankers' acceptances are held in its own portfolio. However, some are rediscounted to unrelated third parties. The taxpayer explained those transactions as follows:

> On May 20, 1988, the [taxpayer] created a bankers acceptance from a draft(s) of [company]. The bankers acceptance obligates [company] (i.e. the drawer) to pay the [taxpayer] (or a subsequent holder in due course) the face value of the acceptance upon maturity. In this example, a $3,000,000 face value acceptance was created on May 20, 1988. On that date [taxpayer] disbursed the discounted funds (i.e. face value less interest to be earned if held to maturity) of $2,979,669.17 to [company]. The acceptance had a maturity date of June 20, 1988.
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> . . . the [company] acceptance which was created on May 20, 1988 was rediscounted to the New York branch [of taxpayer] for a discounted price of $2,983,604.17. On May 26, 1988 the New York branch rediscounted or sold this securitized instrument to an unrelated third party for a discounted price of $2,985,208.33. The gross income earned by [taxpayer] is the difference between the discounted funds received from the unrelated third party and the discounted funds disbursed to [company].

Discounted Funds from sale	$2,985,208.33
Discounted Funds disbursed to [company]	2,979,669.17
Taxable gross income	$ 5,539.16

The Department taxed the entire difference between the face value at maturity ($3,000,000) and the funds disbursed to [company] ($2,979,669.17), or $20,330.83. The taxpayer explains that it believes the auditor taxed the entire discount because of

> the unique accounting method required by the foreign head office. As explained in the attached letter. . . dated August 17, 1988, to the field auditor, the [taxpayer] records the income from rediscounted acceptances using a "gross" presentation. The following, using the [company] example, indicates how the [taxpayer] records the income using a "gross" presentation:
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> | | |
> |---|---|
> | Gross discount | $20,330.83 |
> | Discount expense | (14,791.67) |
> | Net taxable discount earned | $ 5,539.16 |

The letter referred to by the taxpayer explains the taxpayer's accounting as follows:

> Within the United States [bankers' acceptances] are generally regarded as securities, in the sense that banks serve as agents taking a commission for creating a financial instrument which is sold in the marketplace. Because of this convention, our colleagues at domestic banks book only the net commission to income, and pay Washington State business and occupation tax accordingly.
>
> The European accounting convention is a little different. [Bankers' acceptances] are called "trade bills", and European banks often choose to break the mathematical steps of [bankers' acceptances] creation down on the ledger. Since [taxpayer] is required by its parent to use the . . . ledger system, the initial gross income appears larger than it would under a United States presentation. For several years we have felt that a correct calculation for tax purposes therefore involves going beyond the gross effects of our unique accounting convention, and paying tax on the commission of the [bankers' acceptances] as do our American counterparts.

The taxpayer also protests the late payment penalty on the assessment. Taxpayer explains that it had been working with the Department's auditor on the matter, but had been unable to resolve the question regarding the tax on the bankers' acceptances. Taxpayer states that it did not realize, upon receiving the assessment on September 17, 1988, that this was a final assessment. The assessment was due on October 21, 1988. The taxpayer did not note the statement on the assessment that explains that a 10% penalty is due for failure to pay the assessment on time. The taxpayer met with its tax advisor on October 26, 1988, and at that time the taxpayer and advisor realized that the due date had passed. The assessment was paid on November 16, 1988.

DISCUSSION:

RCW 82.04.080 defines "gross income" 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, <u>gains realized from trading in stocks, bonds, or other evidences of indebtedness</u>, 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.

WAC 458-20-146 (Rule 146), the Department's duly authorized administrative rule dealing with banks and financial institutions, states, in relevant part, as follows:

> SERVICES AND OTHER ACTIVITIES. Generally, the gross income from engaging in financial businesses is subject to the business and occupation tax under the classification service and other activities. Following are examples of the types of income taxable under this classification: Interest earned (including interest on loans made to nonresidents unless the financial institution has a business location in the state of the borrower's residence which rendered the banking service), commissions earned, dividends earned, fees and carrying charges,

charges for bookkeeping or data processing, safety deposit box rentals.

Excise Tax Bulletin 165.04.109 [ETB 165], relied on by the auditor, discussed the "netting" of interest expense and interest income. That ETB stated that no offset of interest expense against interest income would be allowed when the parent corporation paid the total amount of interest expense on loans it secured for its subsidiary corporations and was reimbursed by the subs.

The taxpayer argues that ETB 463.04.146 should be applied to it, instead of ETB 165. ETB 463 discusses the taxability of participating loans. That ETB states that when a lending institution sells a loan it is authorized to sell, the institution acts merely as a conduit in collecting the assigned interest and that interest is not income to it but is instead taxable only to the assignee of the loan.

[1] An acceptance is a signed promise by the drawee, rather than the drawer, of a draft that the draft will be honored at maturity.[1] A draft is a dated paper by which a named and signed drawer orders a named drawee to pay to the order of a payee. The payee may or may not be named.[2] Until the drawee formally acknowledges or accepts the drawer's order on the draft, the drawee is not liable on the draft.[3] In the United States, the drawee's acceptance must be written on the draft itself.[4] The drawee is primarily liable, and a drawer is secondarily liable.[5] A bankers' acceptance is an acceptance where the drawee is a bank. The drawee's promise is the act of accepting the obligation to pay. At the same time, the drawer executes an agreement with the acceptor that, in consideration for the bank's accepting the draft drawn by the drawer, the drawer will pay the bank the amount of each draft

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[1]McCullough, Burton V., Letters of Credit §6.02 (Matthew Bender, 1989).

[2]Letters of Credit and Bankers' Acceptances 1988, Reade H. Ryan, Jr., Chairman. Commercial Law and Practice Course Handbook Series (Practicing Law Institute, 1988) p.215.

[3]Id, UCC §3-409(1)

[4]Id, UCC §3-410(1).

[5]Id.

the bank may accept and that it will pay that amount on or before the last business day before its maturity, together with an appropriate acceptance commission for the bank's taking the credit risk for it.[6] This commission is often the discount, or the difference between the amount the drawer actually receives and the face value of the draft. The principal use of a bankers' acceptance is to permit the drawer to use the credit of a bank, the drawee, to facilitate the acquisition of money.[7] These bankers' acceptances are negotiable instruments. The market for them is an over-the-counter market of brokers and dealers which purchase and sell investment paper such as this.[8] They are highly fluid and readily marketable for two main reasons--they are traded at lower rates of discount than certificates of deposit and the holder has a secondary right of recourse against the drawer.[9]

The drawer of the acceptance generally has the acceptance discounted by the acceptor bank. In the case the taxpayer cited, that means that the bank gives the drawer of the acceptance the discounted value of the $3 million, or $2,979,669.17. The acceptor bank, in this case the taxpayer, may later rediscount the acceptance in the acceptance market, or it may hold the acceptance until maturity. If rediscounted, the rate will normally be lower than the original discount rate. In the taxpayer's example, the rediscount was $2,985,208.33 when sold to the unrelated third party. Ultimately, the bank receives the $3 million from company which it must pay to the holder of the acceptance. In this case, the taxpayer's income is $5,539.16, or the difference between the amount given to [company] and the amount received from the unrelated third party.

In this case, we agree with the taxpayer that it should not be subject to tax on amount of discount remaining when the acceptance was sold to the unrelated third party. This transaction is essentially the creation and sale of a security. We point out, however, that the reason the auditor treated the transactions as he did is not because he did not understand the nature of a bankers' acceptance or the

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[6]Id, p. 217.

[7]Id, p. 216.

[8]McCullough, §6.03.

[9]Id.

taxpayer's books, but because he saw no evidence any of the acceptances were rediscounted to unrelated third parties. We therefore are referring this issue back to the audit section for factual verification on this issue.

Secondly, taxpayer has argued that it should not have had to pay the penalty because it did not understand that it had received a final assessment.

RCW 82.32.050 provides as follows:

> If upon examination of any returns or from other information obtained by the department it appears that a tax or penalty has been paid less than that properly due, the department shall assess against the taxpayer such additional amount found to be due and as to assessments made on and after May 1, 1965, including assessments for additional tax or penalties due prior to that date shall add thereto interest at the rate of nine percent per annum from the last day of the year in which the deficiency is incurred until date of payment. The department shall notify the taxpayer by mail of the additional amount and the same shall become due and shall be paid within ten days from the date of the notice, or within such further time as the department may provide. <u>If payment is not received by the department by the due date specified in the notice, or any extension thereof, the department shall add a penalty of ten percent of the amount of the additional tax found due.</u> If the department finds that all or any part of the deficiency resulted from an intent to evade the tax payable hereunder, a further penalty of fifty percent of the additional tax found to be due shall be added.

Emphasis added.

RCW 82.32.105 allows the Department to waive penalties when it finds that the late payment was due to "circumstances beyond the control of the taxpayer." The Department has no other authority to waive penalties on an assessment. In this case, the taxpayer did not realize that the assessment it received was a final assessment with a fixed due date. While we understand that taxpayer may have been unfamiliar with the process of assessment, we are unable to waive penalties in this case where the taxpayer simply failed to realize that the tax was due on a specified date.

DECISION AND DISPOSITION:

Taxpayer's petition is granted in part and denied in part. The file shall be returned to the Audit Section so that the taxpayer may provide evidence regarding the bankers' acceptances. The taxpayer is entitled to the tax treatment outline in section [1] of this determination, and an appropriate refund shall be issued. The taxpayer's petition is denied as to the late penalty issue, except that the portion of the penalty imposed on taxes that are refunded to taxpayer shall be refunded.

DATED this 23rd day of November 1989.