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

In the Matter of the Petition For Correction of Assessment and Refund of	)	D E T E R M I N A T I O N
	)	No. 89-476
. . .	)	Registration No. . . .
	)	. . . /Assessment No. . . .
and	)	
. . .	)	Registration No. . . .
	)	. . . /Audit No. . . .
	)	and
	)	Registration No. . . .
	)	. . . /Audit No. . . .

[1] RULE 146: B&O TAX - FEDERAL OBLIGATIONS - INTEREST. Payments of interest on federal securities which are direct obligations of the federal government to banks which own the securities, or participations in them, are exempt under the business and occupation tax under WAC 458-20-146, even though such interest is paid through a federal reserve bank.

[2] RULE 146: B&O TAX - FEDERAL SECURITIES - RESALE/REPURCHASE TRANSACTIONS - SALE/REPURCHASE V. SECURED LOANS - CRITERIA. Ownership of a security (other than a federal mortgage-backed security), and transfer thereof, must have a genuine basis in reality, and sale versus loan cases will turn upon their own particular facts. Criteria for a resale/repurchase transaction to be considered a secured loan will include the legally enforceable

requirement of the seller to repurchase the same security at a predetermined price and by a certain time, the absence of economic risk, and the parties' intent and actions consistent with a secured loan.

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: August 23, 1989

NATURE OF ACTION:

Petition concerning the taxability of interest received on treasury bills through a federal reserve bank, and amounts received on the sale of participations in those securities "sold" under repurchase agreements.

FACTS:

Bauer, A.L.J.-- The taxpayers' business records were examined for the respective periods of January 1, 1982 through June 30, 1986, January 1, 1983 through December 31, 1985, and January 1, 1983 through September 30, 1986, which audits resulted in the above-referenced assessments.

The taxpayers received interest income from a federal reserve bank attributable to their interests in federal securities (mostly treasury bills), which were direct obligations of the federal government. The auditors disallowed the taxpayers' deduction of such interest because payment was not received directly from the U.S. government or its agencies, but through the bank through whom the securities were acquired, and because the auditors could not ascertain from the available documentation (computer confirmations) whether the taxpayers had purchased the actual securities, or merely were entitled to an income or other indirect interest in securities actually owned by other institutions. The auditors further taxed "gains" received on one taxpayer's sale of participations in these securities, which securities were subject to repurchase agreements.

TAXPAYERS' EXCEPTIONS:

The taxpayers' representative explained that the federal government does not currently issue securities to financial institutions except through "correspondent" banks - banks with which the federal reserve bank has a book-entry relationship.

Banks such as the taxpayers here at issue (hereafter designated as "small banks") purchase federal securities through their correspondent banks. They thus take advantage of the correspondent bank's federal reserve bank access, its expertise, the advantage of buying on a larger scale, and other such efficiencies. In Washington there are approximately ninety small banks which deal with five or six correspondent banks.

Virtually all federal securities sold to banks are book obligations computerized in the Federal Reserve Bank. There are typically no actual certificates or paper documents issued to financial institutions - transfers are memorialized simply by computer-generated confirmations. When a small bank wants to buy a federal security, it calls its correspondent bank to buy on its account. The correspondent bank then purchases the security in its own name, where nominal "title" remains in the Federal Reserve computer system. The correspondent bank will show the smaller bank as the true owner in its accounting records by virtue of an off-book entry, and the security (or portion thereof so purchased) will not appear as an asset on the correspondent bank's balance sheet.

Interest and principal are payable on the certificate to the correspondent bank, since title is in that bank's name. The payment is almost simultaneously transferred into the small bank's account at the correspondent bank. The correspondent bank thus serves as a conduit, and in this regard is held to a fiduciary standard. The taxpayers' representative submits that the only reliable places one can look to establish who actually owns a federal security - or a participation in one - are the accounting records of the banks involved - not the Federal Reserve Bank computer which lists the correspondent bank as owner.

Finally, one taxpayer was taxed on its "gains" from the sales of participations in these securities subject to repurchase agreements. The taxpayer argues that these transactions were secured loans rather than true sales, and that the "gains" received were simply a portion of the loan it received.

DISCUSSION:

WAC 458-20-146 provides in pertinent part:

> The deductions generally applicable to financial businesses include the following:
>
> (3) ... interest received on direct obligations of the federal government, but not for interest attributable to loans or other financial obligations on which the federal government is merely a guarantor or insurer.

[1] Thus, interest payments on federal securities which are direct obligations of the federal government to banks which own the securities, or participations in them, are exempt under the business and occupation tax under WAC 458-20-146. It is the obligation of the payment itself which must be direct, not the method of payment. If the federal government is the direct obligor on the security, instead of merely the guarantor, then interest received by the owner of the security - or portion thereof - should be deductible, even if the method of payment is through another bank.

Based on the arguments here presented, and subject to audit verification of the taxpayers' accounting records, we are satisfied that the taxpayers were either owners of the securities or participations in them[1], regardless of the designation of ownership recorded in the computer records in the Federal Reserve System, and were entitled to deduct interest received on them.

One of the taxpayers has further argued that amounts it received from the sale of participations in these securities subject to repurchase agreements were the receipt of secured loans, and that none of these amounts should be classified as "gain." We agree that such "sale" transactions may have been mischaracterized.

[2] Ownership of a security, and transfer thereof, must have a genuine basis in reality. Sale versus secured loan cases will turn upon their own particular facts. In determining whether a transfer of a securities transaction is, in substance, a secured lending transaction instead of an actual

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[1] Absent any further transfer of ownership.

sale and later repurchase, the Department will look to the following criteria, as well as others as may be appropriate[2]:

1. The identical[3] security, or participation, "sold" to the lender is to be repurchased by the "borrower." The actual physical characteristics of the transfer of ownership is not critical, since methods will vary depending on the type of security.

2. The repurchase price is determined at the time of the "sale."

3. The seller is legally bound to repurchase the securities on or before a fixed future date.

4. The entering into of the sale and the obligation to repurchase are simultaneous transactions.

5. Changes in the fair market value of the securities sold do not affect the terms of the transaction. Any deviation which subjects either party to economic risk (such as a repurchase at a future market value) or leaves either party free to alter the predetermined economic relationship (such as an option rather than an obligation to repurchase) would defeat the borrowing rationale.

6. The intent of the parties to enter into a secured loan transaction as opposed to a sale and later repurchase, and actions of the selling party which are consistent with a continuing ownership interest in the securities "sold."[4]

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[2] Except in cases of federal mortgage-backed securities. See Determination No. 89-461, __WTD__(1989).

[3] Or, in some cases, substantially similar.

[4] See Rev. Rul. 74-27, 1974-1 C.B. 24; Rev. Rul. 82-144, 1982-2 C.B. 34,35; Forer, "Accounting, Supervisory and Tax Considerations of Reverse Repurchase Transactions," National Society of Controllers and Financial Officers of Savings Institutions (Technical Publication, July 1974); Commissioner v. Bank of California, 80 F.2d 389 (9th Cir. 1935), aff'g 30 BTA., 556 (1934); Citizens National Bank v. United States, 551 F.2d 832 (Ct. Cl. 1977); United Planters National Bank v. United States, 426 F.2d 115 (6th cir.), cert. denied, 400 U.S. 827 (1970); American National Bank v. United States, 421 F.2d 442 (5th Cir.), cert. denied, 400 U.S. 819 (1970); First American National Bank v. United States, 467 F.2d 1098 (6th Cir. 1972).

If a transfer of a federal security is classified under the above criteria as a secured loan, then the seller (borrower) will be considered for tax purposes to have continued to be its substantial owner. Payment to the seller from the buyer (lender) will therefore be considered the receipt of a loan by the seller, no portion of which will be taxable to the seller as "gain." Further, the seller (borrower), as substantial owner of the security, will be required to report interest paid on the security (even if received and retained by the buyer (lender)), and entitled to deduct that amount as "interest received on direct obligations of the federal government."[5]

In this case, the record before us does not reveal the particulars of the transactions at issue. Therefore, the matter will be remanded to the Audit Section for a further determination of the nature of these transactions, and their taxability, in accordance with the above criteria.

DECISION AND DISPOSITION:

The taxpayers' petitions for correction of assessment and refund are granted. The matter is remanded to the Audit Section for adjustment in accordance with this determination, and refunds or amended assessments, as appropriate, will be issued.

DATED this 28th day of September 1989.

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[5] If the seller (borrower) by virtue of the repurchase agreement permits the buyer (lender) to receive and retain interest payable on the security, the seller (borrower) is deemed to be "paying" the buyer (lender) what is in effect interest on the loan, which is nondeductible income to the buyer (lender). This amount of taxable interest may have been further adjusted by the parties utilizing a differential in the original "sale" and "repurchase" prices. The buyer (lender) will be taxed on the adjusted amount of "interest" received.