

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. 89-445
)
 . . .) Registration No. . . .
) . . . /Audit No. . . .
)

[1] RULE 146: RCW 82.04.4292 -- B&O TAX -- SALE OF
MORTGAGE BACKED SECURITIES -- GAIN -- AMOUNTS
"DERIVED FROM INTEREST" OR TAXABLE GAIN. Gain
received on the sale of a mortgage-backed security
cannot be excluded from income as an amount "derived
from interest" because the amount is not dependent
on whether or not the interest is ever paid. It is
not, therefore, an amount received for the use or
forbearance of money.

[2] RULE 162, RULE 146: GAINS FROM THE SALES OF
SECURITIES -- TRADING GAINS -- APPLICABILITY OF
RULE. When a bank is engaged in essentially the
same activities as a "security house," it is
entitled to the tax treatment granted such entities.

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 CONFERENCE: June 14, 1989

NATURE OF ACTION:

Taxpayer protests the assessment of tax on the gains from the
sale of first mortgages on non-transient residential
properties or securities backed by such mortgages.

FACTS AND ISSUES:

Hesselholt, A.L.J. -- Taxpayer's records were audited for the period January 1, 1983 through December 31, 1986. As a result of the audit, two assessments were issued, one in the amount of \$. . . , and the second for \$. . . , both including taxes and interest. Taxpayer protests that part of the assessments involving the gains and losses on the sale of first mortgages on non-transient residential properties or securities backed by such mortgages.

The taxpayer explains its business as follows:

The taxpayer is a savings and loan association doing business in . . . and Washington. During the course of this business the Taxpayer invests in debt obligations which are primarily secured by interests in residential real property. (All such debt obligations are referred to herein as "MBS").

The modern MBS market has its origins in securities guaranteed by the Government National Mortgage Association (Ginnie Mae) and first issued in 1970. If an issuer or servicer fails to make timely principal and interest payments of GNMA-guaranteed securities, GNMA will continue payments to security holders. In addition to GNMA, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) guarantee mortgage securities backed by residential property loans. Single-family mortgage loans that collateralize GNMA-guaranteed securities are insured or guaranteed by the Federal Home Loan Mortgage Corporation, Veterans Administration, and Farmers Housing Administration. Fannie Mae and Freddie Mac guarantee securities collateralized by seasoned FHA/BA single-family loans as well as investment grade conventional loans.

There are two types of MBSs. One is a pass-through certificate evidencing ownership of an interest in a mortgage loan or a pool of mortgage loans. Principal and interest payments on the underlying mortgages (less servicing fees) are paid or "passed through" to investors. There are several variations of pass-through certificates. A straight pass-through pays principal and interest as they are collected from the mortgage pool. A partially

modified pass-through guarantees that monthly principal and interest payments will be made to a certain extent, even if not collected from the mortgage pool. A modified pass-through guarantees payment of the scheduled monthly principal and interest payments, irrespective of the amounts that are collected from the mortgage pool.

The other type of MBS is an obligation secured by a mortgage loan or pool of mortgage loans. This category includes pay-through or cash flow bonds that are designed so that the required amortization from the collateral pool will at all times be at least equal to the payments of both interest, at the bond coupon rate, and scheduled principal on the bonds. Additional payments of principal are made to bondholders when there are prepayments on the mortgage collateral pool. The life of the bonds, therefore, is determined by the life of the mortgage pool. (Not all pay through bonds are fully amortizing; some have balloon payments due at maturity.)

Government guaranteed MBS are issued by Ginnie Mae, Fannie Mae, or Freddie Mac. Conventional MBSSs (those not so guaranteed) are issued by banks, savings and loans, real estate developers, and mortgage insurance companies.

The Taxpayer participates in the MBS Market in two ways. First, the Taxpayer makes loans directly to borrowers who secure the debt by interests in residential real property. The loans are then "packaged" and sometimes sold as MBS. Second, the Taxpayer purchases MBSSs from other institutions which have issued them.

The Taxpayer collects interest on such MBSSs. From time to time the Taxpayer sells MBSSs and realizes a gain therefrom.

The taxpayer argues that its gains on the sales of MBSSs are

nothing more than the captured present value of the future interest income on the MBS that is in excess of prevailing market rates. The gain realized from the sale of the certificates is a function of the interest rate. Therefore, any gain realized from

the sale of the MBS is an amount derived from interest as required under RCW 82.04.4292.

The auditor taxed the gains realized from the sales of MBSs, stating that

Since March 1983 you have been selling mortgage loans and recording the gains and losses in separate accounts. WAC 458-20-146 specifically includes under gross income of business to be reported ". . . gains realized from trading in stocks, bonds, or other evidences of indebtedness. . . without any deduction on account of losses."

Taxpayer makes the following arguments:

1. Gains from the sales of MBSs are exempt under RCW 82.04.4292 as amounts derived from interest.
2. Even if the gains are taxable, the taxpayer should be able to "net" such gains under the provisions of WAC 458-20-162 for each month.
3. If the gains are taxable, then the amounts should be apportioned under the standards set forth in Pacific First Federal Savings & Loan Assn v. Washington, 92 Wn.2d 402 (1979).

DISCUSSION:

RCW 82.04.4292 provides

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.

Taxpayer argues that the gains from the sales of these MBSs constitute amounts "derived from interest received on investments or loans primarily secured by first mortgages" We agree that the MBSs represent investments or loans "primarily secured by first mortgages." We do not agree that the amounts are "derived from interest."

Taxpayer has cited the dictionary definition of "derived":

1. To receive or obtain from a source.
 2. To arrive at by reasoning: deduce or infer.
 3. To trace the origin or development of (e.g., a word).
- .

(Dictionary unidentified.)

Taxpayer argues that the gain on the sale originates from the interest rate, and therefore "derives" from it under the statute. Taxpayer states that

gains on sales of MBSs are nothing more than the captured present value of the future interest income on the MBS that is in excess of prevailing market rates. The gain realized from the sale of the certificates is a function of the interest rate. Therefore, any gain realized from the sale of the MBS is derived from interest as required under RCW 82.04.4292.

Taxpayer states that words used in a statute must be given their ordinary and common meaning (Publishers Forest Products Co. v. State, 81 Wn.2d 814 (1973)), and that this gain falls under that definition. Further, taxpayer quotes from Determination No. 88-255, 6 W.T.D. 123 (1988)

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 point, for example, have been held to constitute "interest."

Id., at 128.

Thus, taxpayer argues, since "discount income" may be interest, this income, which is the gain realized on the sale of the MBSs, is the same thing.

[1] As quoted above in Determination No. 88-255, interest is merely a charge for the use or forbearance of money. Security Savings Society v. Spokane County, 111 Wash 35 (1920). A "forbearance" is an "act by which creditor waits for payment of debt due him by debtor after it comes due [citations

omitted]."
Gain, on the other hand, is defined as

Profits; winnings; increment of value. Difference
between receipts and expenditures; pecuniary gain. .

"Gain derived from capital" is a gain, profit, or
something of exchangeable value proceeding from the
property, severed from the capital however invested,
and received or drawn by claimant for his separate
use, benefit, and disposal. Commissioner of
Internal Revenue v. Simmons Gin Co., 43 F.2d 327,
328 (CCA 10, ____).

Black's, supra.

While we agree that the gains are related to the interest
rate, we do not think that this rationale can be extended so
as to arrive at the proposition that the gains are actually
"amounts derived from interest received." To come to such a
conclusion, we would have to determine that the gain 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 security.

ETB 463.04.146 is currently the only published Departmental
guidance which address 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 MBS is sold by the taxpayer to another party. The taxpayer no longer has an investment in the MBS, and its money is thus not being used by the borrower. We would thus be hard pressed to hold that the gain 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 gain received by the taxpayer in this case is not an amount derived from "interest received" simply because the taxpayer receives a gain. The gain 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 sale.

Accordingly, the gain received by the taxpayer here at issue is not "for the use or forbearance of [its] money," since the taxpayer has already been fully reimbursed for the face amount of the MBS originally made to the borrower. Further, the gain payment is not a charge for the use or forbearance of the taxpayer's money. Therefore we hold that the gain received by the sale of MBSs is taxable as a gain from the sale of "evidences of indebtedness" RCW 82.04.080. However, the amount received for the interest that has accrued prior to the sale would be excludable under the statute.

2. If the gains are taxable, the taxpayer should be able to "net" the gains under WAC 458-20-162.

WAC 458-20-162 (Rule 162) provides, in relevant part, 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;

GROSS INCOME FROM TRADING. Gross income from trading is the amount received from the sale of stocks, bonds and other securities over and above the cost or purchase price of such stocks, bonds and other securities. In the case of short sales gross earnings shall be reported in the month during which the transaction is closed, that is, when the purchase is made to cover such sales or the short sale contract is forfeited.

[2] Under the rule, a taxpayer is allowed to "net" its gains and losses in any one account on a monthly basis. No losses may be carried forward.

Here, taxpayer is buying and selling mortgage backed securities. Where a financial institution is engaged in the business of trading in securities, it is liable for business and occupation tax measured by "gross income from trading" as defined by Rule 162.

3. Taxpayer should be able to apportion its gains.

Taxpayer complains that its gain from the sale of the mortgages was not apportioned between . . . and Washington. Taxpayer argued that since the funds used in the investment come from both the . . . and Washington places of business, it is entitled to that treatment. Taxpayer's other income was apportioned, but apparently the taxpayer did not discuss this issue with the auditor. In Pacific First Federal Savings & Loan Assn v. Washington, 92 Wn.2d 402 (1979), the Washington Supreme Court found that [a S & L] was entitled to apportion "its income from liquid fund investments" Id, at 409, because the funds which were used for the investments came both from . . . and Washington. This situation is no different from the one presented in [that] court case.

DECISION AND DISPOSITION:

Taxpayer's petition is granted in part and denied in part. Taxpayer is not entitled to exempt its gain from the sale of MBSS, other than the amount that represents the accrued interest at the time of sale, but is allowed to apportion it and to "net" it each month under the provisions of Rule 162. The file shall be returned to the Audit Section to issue an amended assessment, to be due on the date stated therein.

DATED this 30th day of August 1989