

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

In the Matter of the Petition)	<u>D</u> <u>E</u> <u>T</u> <u>E</u> <u>R</u> <u>M</u> <u>I</u> <u>N</u> <u>A</u> <u>T</u> <u>I</u> <u>O</u> <u>N</u>
For Refund of)	
)	No. 89-460
)	
. . .)	Registration No. . . .
)	
)	

[1] RULE 146: B&O TAX -- MORTGAGE-BACKED SECURITIES -- INTEREST. Because GNMA, FNMA, AND FHLMC mortgage-backed securities are primarily secured by residential mortgages, interest payments to owners of such securities, or participations in them, are exempt under the business and occupation tax under RCW 82.04.4292.

[2] RULE 146: B&O TAX -- MORTGAGE-BACKED SECURITIES -- INTEREST -- OWNERSHIP. In determining whether a taxpayer's interest in a mortgage-backed security is an ownership interest, or merely a security interest in a financing transaction, the Department will be guided by the mortgage-backed security accounting provisions contained in 12 C.F.R. § 571.16.

[3] RULE 146: B&O TAX -- MORTGAGE-BACKED SECURITIES -- SALE OF -- ACCRUED INTEREST. Amounts received from buyers of federal mortgage-backed securities (GNMA, FNMA, and FHLMC) for interest accrued by taxpayer-sellers prior to sale dates will constitute "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties," and are thus deductible.

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: February 13, 1987

NATURE OF ACTION:

Petition concerning the taxability of interest booked pursuant to GNMA dollar rolls, and payments received from buyers of mortgage-backed securities representing accrued interest.

FACTS:

Bauer, A.L.J. -- On December 10, 1986, the taxpayer received a determination of the amount of refund it would receive from its overpayment of business and occupation taxes on interest on GNMA securities, which interest had been declared exempt by the Department. The examiner disallowed a portion of the claimed refund.

TAXPAYER'S EXCEPTIONS:

The taxpayer petitions the Department for a correction of the amount of the refund it received. At issue are (1) interest booked in conjunction with its "GNMA dollar rolls" and (2) payments of accrued interest received from buyers when its GNMA securities were sold. The taxpayer calculates that it is due an additional \$15,475, plus statutory interest on that amount.

During the audit period, the taxpayer dealt in federal mortgage-backed certificate transactions which it calls "GNMA dollar rolls." The taxpayer has given the following hypothetical as typical of such a transaction:

The taxpayer owned a mortgage-backed security representing an existing 9% \$1M GNMA pool which it had purchased March 27, 1986. The outstanding balance of principal owing at the time of purchase was \$733,343. On June 23, 1986, the taxpayer "sold" the GNMA security to another bank (hereafter "B") for 96-29¹ of the principal balance owing on the pool plus 22 days of accrued interest, subject to an agreement to repurchase it at 96-22, plus accrued interest, by November 24, 1986². The

¹ "96-29" is bank parlance for 96-29/32%.

² The repurchase date could have also been extended by a "rollover," accounting for the taxpayer's calling these

outstanding principal balance at that time was \$730,734. Title was transferred to "B" by way of a computer confirmation.

Interest and principal were paid to "B" during the period it owned the pool. Banking regulations also required that the taxpayer-seller book the interest as income, and a commensurate amount as a borrowing cost.

On November 24, 1986, as agreed, the taxpayer repurchased from "B" a similar GNMA security³ at the agreed price of 96-22 of the outstanding principal amount plus 23 days of accrued interest.

The taxpayer contends that the interest it was required to book when the security was owned by "B" should be deductible.

Further, the taxpayer argues that payments from buyers of its mortgage-backed securities for interest accrued by the taxpayer prior to the effective dates of sale are in effect deductible interest and should not be taxed as "trading gains."

ISSUES:

The two issues for our resolution are as follows:

1. Whether interest booked by the taxpayer pursuant to federal regulations on "GNMA dollar rolls," even though such interest is not actually received, is taxable under the business and occupation tax.

transactions "dollar rolls." A rollover or extension of such an agreement occurs when an institution decides not to accept delivery of the security on the agreed-upon date, but rather decides to "roll it forward" by means of a sell/buy transaction in which the position is offset and extended for another specified period of time. The institution must repurchase the security within twelve months of the initial sell/buy transaction.

³ The GNMA security repurchased was collateralized by similar mortgages with similar maturities resulting in approximately the same market yield, had an identical coupon interest rate, and the aggregate principal amount was within the accepted "good delivery" standard required by the Public Securities Association (PSA).

2. Whether accrued payments of interest received from buyers of federal mortgage-backed securities are taxable as trading gains.

DISCUSSION:

[1] As a preliminary matter, because GNMA⁴ mortgage-backed securities are primarily secured by residential mortgages, interest payments to owners of such securities, or participations in them, are exempt under the business and occupation tax under RCW 82.04.4292.

Federal mortgage-backed securities are regularly traded between financial institutions in various types of resale and repurchase transactions, as financial institutions' needs for financing, cash, and liquidity dictate. Some of these transactions are in the nature of purchases and sale arrangements, and some are more in the nature of secured loans. The overall question for the purpose of determining who is entitled to take the interest deduction then becomes "who really owns the security?"

[2] To determine whether a taxpayer's interest in a mortgage-backed security is an ownership interest, or merely a security interest in a financing transaction, the Department will be guided by the mortgage-backed security transaction accounting provisions contained in 12 C.F.R. §571.16,

In this taxpayer's hypothetical transaction, it agreed to sell a mortgage-backed security from its investment portfolio to another institution ("B"), subject to an agreement to subsequently repurchase a similar mortgage-backed security from "B" within a specified time at an agreed-upon price. The taxpayer transferred title in the security to the purchasing institution "B" (memorialized by a computer-generated confirmation), and "B" received payments of principal and interest during the term of the contract, when it "owned" the security. The taxpayer in due course repurchased from "B" a substantially-similar security at the agreed-upon price within the time period specified in the contract.

Under §571.16(c), the described transaction is a "dollar reverse-repurchase agreement," which is required to be accounted for as a collateralized borrowing arrangement (financing) since the security repurchased by the taxpayer was

⁴ As well as FNMA AND FHLMC mortgage-backed securities.

"substantially similar" to the one originally sold. Had the repurchase date been "rolled forward" by the taxpayer, the transaction would have been a "dollar reverse-repurchase agreement with a rollover or extension" under §571.16(d), also accounted for as a financing assuming all other facts were the same.

Thus, because the hypothetical transaction is a financing arrangement, and because the transfer of the mortgage-backed security to "B" (the lender in the financing arrangement) was for security purposes only, interest earned thereon paid to "B" is that of the taxpayer - the true owner⁵. The taxpayer, still being the true owner of the security and the interest earned thereon, may therefore deduct that interest, even though it has been paid to "B," assuming the taxpayer has "booked" and included such interest in the gross amount it has reported on its return.

The taxpayer's petition as to this issue is granted.

As to the taxpayer's argument that amounts paid by a purchaser of a federal mortgage-backed security (whether GNMA, FNMA, or FHLMC) for interest accrued before the sale date is deductible, we agree. It is generally recognized that when an accrual basis taxpayer has recognized, or is required to recognize, accrued interest in its books of account, it has "received" such amount for state tax purposes. See WAC 458-20-199.

Further, the "amount" in question, which is actually received from the buyer as part of the security's agreed purchase price, is based on and is equal to the interest which has been accrued by the taxpayer-seller prior to the date of the security's sale. This amount is normally recorded by both buyer and seller in their respective interest accounts.

⁵ The taxpayer (borrower), by virtue of the dollar reverse-repurchase agreement, has permitted "B" (the lender) to receive and retain all interest paid on the security in exchange for its use of "B's" money. The actual effective interest rate for the loan has been achieved at the outset by setting the agreed-upon repurchase price to attain the correct payment to "B." "B" will be taxed on the amount of interest earned from these sources in exchange for the taxpayer's use of its money during the period of the contract.

[3] Thus, amounts received by sellers from buyers of federal mortgage-backed securities (GNMA, FNMA, and FHLMC) for interest accrued by sellers prior to sale dates will constitute "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties," and thus be deductible by sellers.⁶

The taxpayer's petition as to this issue is granted.

DECISION AND DISPOSITION:

The taxpayer's petition for refund is granted. A warrant or credit, with statutory interest thereon, will be issued in due course.

DATED this 18th day of September 1989.

⁶ The buyer will not be entitled to deduct these amounts as "interest received on direct obligations of the federal government." The amount attributable to the accrued interest, however, will be includable in the buyer's "cost or purchase price of such ... securities" in calculating gross income from trading under WAC 458-20-162.