

Cite as Det. No. 03-0079, 23 WTD 83 (2004)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 03-0079
...)	
)	Registration No. . . .
)	TAS . . . /Audit No. . . .
)	Docket No. . . .
)	

- [1] RCW 82.04.4292: B&O TAX -- DEDUCTIONS -- INTEREST ON FIRST MORTGAGES OF RESIDENTIAL PROPERTY -- MORTGAGE BROKER -- FINDERS FEES. Where a first mortgage on residential property was closed in the name of the financial institution that was funding the loan, the amounts paid to a mortgage broker for finding and facilitating the customer's loan were for services rendered and not deductible as interest under RCW 82.04.4292.

- [2] RCW 82.04.4292: B&O TAX -- DEDUCTIONS -- INTEREST ON FIRST MORTGAGES OF RESIDENTIAL PROPERTY -- YIELD SPREAD PREMIUMS. Where a first mortgage on residential property was closed in the name of the lending institution, a yield spread premium paid by the lending institution to a mortgage broker for closing a loan at a percentage higher than the prevailing rate was for brokerage services rendered and not deductible as interest under RCW 82.04.4292.

- [3] RULE 224: B&O TAX -- GROSS INCOME -- EXCLUSION -- LOAN ORIGINATION FEES -- TRANSACTION FEES. Where a lending institution charges a loan applicant a loan origination fee, the amounts that the institution retains for transacting and processing the loan prior to paying the broker its commission are not included as income to the mortgage broker.

- [4] RULE 229: PETITIONS FOR REFUNDS -- ESTOPPEL -- CONDITIONAL REFUNDS. Under Rule 229, when refund requests are initiated by a petition of a taxpayer, the Taxpayer Account Administration Division grants a refund on a conditional basis and subject to future field audit verification. When the Audit Division later examines taxpayer's records to verify the refund, it is not estopped

from re-assessing taxes properly due if it determines the refunded amount was improper.

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.

Okimoto, A.L.J. – A mortgage broker protests the assessment of business and occupation (B&O) taxes on loan origination fees (LOF) and yield spread premiums. We deny Taxpayer's claim that LOF and yield spread premiums qualify for a deduction from tax under RCW 82.04.4292. We grant Taxpayer's petition to exclude from income amounts retained by the actual lender for processing and transaction fees from the LOF paid. We deny Taxpayer's estoppel argument.¹

ISSUES

- 1) Are LOF earned by a mortgage broker for soliciting and closing loans for a finance company deductible from B&O taxes under RCW 82.04.4292?
- 2) Are yield spread premiums (YSP) deductible from B&O tax?
- 3) May Taxpayer exclude transaction fees and processing fees retained by the lender from its gross income?
- 4) Is the Department of Revenue (DOR) precluded from assessing B&O taxes in an audit report because it issued a refund check to Taxpayer in 1999?

FINDINGS OF FACT

. . . (Taxpayer) is a mortgage brokerage company based in . . . , WA. Taxpayer's books and records were examined by the Audit Division (Audit) of the Department of Revenue (DOR) for the period February 14, 1997 through September 30, 2000. The examination resulted in additional taxes and interest owing of \$. . . and Document No. . . . was issued in that amount on August 1, 2001. Taxpayer paid the unprotested portion of the assessment (\$. . .) and the balance remains due.

Taxpayer is an independent loan representative for . . . (Mortgage). Taxpayer explains that a typical loan transaction occurs as follows:

- 1) A customer contacts Taxpayer wishing a loan on its home.
- 2) Taxpayer helps the customer fill out a loan application and submits the application to Mortgage.

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

- 3) Mortgage pulls a credit report on the customer and determines the type and amount of loan that the customer qualifies for based on the credit report, the application, and other financial information.
- 4) Mortgage approves or denies the loan.
- 5) If approved, Mortgage funds the loan through its line of credit.

At time of closing, the customer pays a standard 1% loan origination fee. This fee is paid to Mortgage during escrow, which in turn pays Taxpayer. On a \$100,000 loan, the LOF would be \$1,000. The escrow agent pays \$1,000 to Mortgage and Mortgage retains a \$425 transaction fee and a \$250 processing fee. Mortgage pays Taxpayer the balance as its commission.

During the summer of 1999, a colleague at work told Taxpayer that it did not have to pay tax on its income. Consequently, Taxpayer wrote a letter to DOR on September 14, 1999 asking for a refund of all taxes paid. Taxpayer's letter stated:

Please refund all B&O taxes paid by [Taxpayer] for 1997, 1998, and the first quarter of 1999. These taxes were paid in error, as I didn't fully understand how to complete the forms. All revenues generated by [Taxpayer] to date have been from loan origination fees that are secured by first mortgages on nontransient residential properties. These fees are based on a percentage of the principal amount, representing an interest yield adjustment charged on loans. These loan origination fees are not subject to tax as they are considered interest on the first mortgage and are deducted as such as per the Revised Code of Washington.

Based solely on the representations made by Taxpayer in its letter, Taxpayer Account Administration (TAA) of DOR issued a refund check for all B&O taxes previously paid by Taxpayer. Although Taxpayer contended that he received written instructions from TAA with the refund check, the facts do not support Taxpayer's assertion. DOR's file does not contain any written instructions to Taxpayer and Taxpayer could not produce the original. Furthermore, TAA stated that: "... the refund was a self-mailer that contained the check and a tear off portion that stated the codes and reasons for the refund and a statement that the refund was subject to future verification." Letter to Taxpayer from . . . , dated April 26, 2002. We find these facts stated in the April 26, 2002 letter to be reasonable and credible.

On January 11, 2001, the Audit Division (Audit) sent an appointment letter to Taxpayer notifying Taxpayer of its intent to examine Taxpayer's books and records. Fieldwork began on February 1, 2001 which resulted in the above tax assessment. In Schedules 2 and 4, Audit assessed B&O tax on the 1% loan origination fees for mortgage brokerage services. Audit did not allow Taxpayer to deduct transaction fees and processing fees retained by Mortgage.

In the Independent Loan Representative Agreement between Taxpayer and Mortgage the following facts were recited. Mortgage is in the business of making real estate loans whereas Taxpayer is in the business of soliciting loan applications for various loan products from the home buying public. Taxpayer may submit a loan application to Mortgage for its consideration. Taxpayer is an independent contractor and not an employee. Taxpayer shall originate real estate

loans by contacting the public and using his/her best efforts to originate a minimum of three loans per month. Mortgage shall make available to Taxpayer office space and furniture, office equipment, telephone, receptionist, program and rate information, and processing and accounting support.

Under the agreement, Mortgage paid Taxpayer the following fees for its brokerage services based on all applications accepted for processing by Mortgage: “100% of the net loan origination fee and 100% of all overages of points, discounts or rebates received by [Mortgage] on any of his or her loans less a transaction fee of \$425 if the total compensation due [Taxpayer] is less than \$3000”

In addition, Audit assessed B&O taxes on yield spread premiums (YSP) earned by Taxpayer. YSPs occur when Taxpayer obtains a quote and guarantees a specified interest rate for a customer but does not actually lock into the quoted rate with Mortgage. If rates go down, the customer’s loan can be funded by Mortgage at a lower cost and thereby earning Taxpayer a YSP from Mortgage. If rates go up, however, Taxpayer must absorb the additional costs to Mortgage. Taxpayer relies on Det. No. 88-255, 6 WTD 123 (1988), in support of its position that YSP are interest.

ANALYSIS

Washington imposes a B&O tax upon all persons for the act or privilege of engaging in business within the state. RCW 82.04.220. Mortgage brokers, such as Taxpayer, are generally taxed under the service and other activities tax classification² measured by the gross income of the business. RCW 82.04.290. Gross income means “the value proceeding or accruing by reason of the transaction of the business engaged in and includes . . . , compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however, designated.” RCW 82.04.080.

[1] RCW 82.04.4292 provides a tax deduction for interest received on loans primarily secured by first mortgages on nontransient residential property. We use rules of statutory construction to determine if a taxpayer is entitled to a tax exemption, deduction, or credit. Statutes granting an exemption from taxation must be narrowly construed. Deductions and exemptions are strictly construed against the taxpayer. *Budget Rent-a-Car, Inc. v. Department of Rev.*, 81 Wn.2d 171, 500 P.2d 764 (1972). Thus, “the burden of showing qualification for the tax benefit afforded likewise rests with the taxpayer.” *Group Heath Co-op. v. Tax Comm’n*, 72 Wn.2d 422, 429, 433 P.2d 201 (1967).³

² For periods between July 1, 1993 and June 30, 1998 Taxpayer was required to report under the Financial Business Services tax classification. That classification was repealed, effective July 1, 1998.

³ Tax exemption statutes must be strictly construed in favor of the application of the tax. *Yakima Fruit Growers Association v. Henneford*, 187 Wn. 252, 60 P. 2d 62 (1936). No person should be declared exempt unless it clearly appears that such exemption is required by law. *North Pacific Coast Freight Bureau v. State*, 12 Wn.2d 563, 122 P. 2d 467 (1942). Any claim of exemption is to be studied with care before depriving the state of revenue. *Alaska*

In order to qualify for the RCW 82.04.4292 B&O tax deduction DOR has held that the person claiming the deduction must satisfy the following test.

- A. The person is engaged in banking, loan, security, or other financial business;
- B. The amount deducted was derived from interest received;
 - 1. There must be a legally enforceable obligation of the debtor to pay the creditor. Usury, statute of limitations, or other statute must not bar the payment.
 - 2. The debtor must have made the payment or the payment was made on behalf of the debtor. The gain from the sale of loans is not interest.
 - 3. The payment must not be for specific services such as a finder's fee, document preparation, title examination fees, notary fees, etc. To the extent that a fee charged to a borrower is for a combination of services and compensation for the use or forbearance of money, the fee will be allocated between service income and interest income.
- C. The amount deducted was received because of a loan or investment. The taxpayer was the owner of a loan or investment. The owner of a loan or investment is the party who is entitled to receive the principal of the loan. Stated another way, the owner of the loan or investment is the person [who] retains the risk of interest rate fluctuations.
- D. The loan or investment is primarily secured by a first mortgage or deed of trust;
- E. The first mortgage or deed of trust is on nontransient residential real property.

Det. No. 99-241, 19 WTD 295, 299-300 (2000)

In Det. No. 99-241, we held that because the loan was closed in the name of the financial institution that was funding the loan and the fees were received by the mortgage broker as a finder's fee, the broker was engaged in "pure mortgage broker" activities. Consequently, the fees received by that broker were for "services rendered" and did not qualify for the deduction allowed by RCW 82.04.4292. Similarly, in Taxpayer's case, the loans are closed in the name of Mortgage and not Taxpayer. In addition, Taxpayer also receives a net loan origination fee for its services similar to a finder's fee.⁴ We therefore conclude that Taxpayer is not entitled to the deduction allowed by RCW 82.04.4292 on LOF income actually received by Taxpayer.

[2] Nor is Taxpayer entitled to deduct amounts received as YSP under RCW 82.04.4292. Taxpayer again fails to satisfy requirement "C" in the above test, since it is not the owner of the loan or investment. Mortgage owns the loan in all cases. In addition, we consider the YSP to be a part of Taxpayer's overall compensation that it receives from Mortgage for performing "pure mortgage broker" services. Mortgage allows Taxpayer to speculate on interest rate fluctuations by allowing Taxpayer to not lock into a quoted interest rate at the time of application. If the loan

Steamship Company v. State, 31 Wn.2d 328, 196 P. 2d 1001 (1948). In general, tax exemption statutes must be strictly construed in favor of the tax. *Miethke v. Pierce County*, 173 Wn. 381, 23 P. 2d 405 (1933).

⁴ The . . . [Mortgage] . . . Agreement specifically states: ". . . [Independent loan representative] shall be compensated for his or her services with regard to the loan applications for processing by [Mortgage] by payment of the [independent loan representative] fee structure"

that actually closes is less costly because interest rates have gone down, then Taxpayer receives a YSP on its fee for brokerage services from Mortgage. If interest rates rise, Taxpayer's fee for services is reduced by Mortgage. Either way, however, the amount Taxpayer receives remains a fee for its services performed and is not interest. Accordingly, Taxpayer's petition is denied on the YSP.

[3] A loan origination fee is charged by the lender to cover the lender's administrative processing of its loan. Det. No. 89-280, 7 WTD 375 (1989). Consequently, it is Mortgage that is entitled to the entire fee. Under Taxpayer's agreement with Mortgage, Taxpayer only receives a finder's fee or commission for its services, which is computed as follows:

A. [Mortgage] shall pay to the [independent loan representative] 100% of the net loan origination fee and 100% of all overages of points, discounts or rebates received by [Mortgage] on any of his or her loans less a transaction fee of \$425 if the total compensation due [independent loan representative] is less than \$3000, \$525 if the total compensation due [independent loan representative] is between \$3000 and \$4999...

Since Mortgage retains transaction and processing fees before it pays to Taxpayer its finder's fee, Taxpayer never receives the retained portion of the LOF. Furthermore, the retained portion of the LOF is used to offset Mortgage's own costs of processing the loan and not Taxpayer's costs.⁵ Therefore, we agree with Taxpayer that this portion of the LOF is not income to Taxpayer and may be excluded. Taxpayer's petition is granted on this issue.

[4] Next, we reject Taxpayer's argument that DOR is estopped from assessing taxes because it previously granted a refund at Taxpayer's request. WAC 458-20-229 (Rule 229) is the lawfully promulgated rule covering DOR's procedure for granting refunds. It states in pertinent part:

(3) **REFUND/CREDIT PROCEDURES.** Refunds are initiated in the following ways:

...

(b) Taxpayer request. When a taxpayer discovers that it has overpaid taxes, penalties, or interest, it may file an amended return or a petition for refund or credit with the department. The petition or amended tax return must be submitted within the statute of limitations. Refund or credit requests should generally be made to the division of the department to which payment of the tax, penalty, or interest was originally made. The amended tax returns or petitions are subject to future verification or examination of the taxpayer's records. If it is later determined that the refund or credit exceeded the amount properly due the taxpayer, an assessment may be issued to recover the excess amount, provided the assessment is made within four years of the close of the tax year in which the taxes were due or prior to the expiration of a statute of limitations waiver.

⁵ It seems reasonable to conclude that the administrative costs that Mortgage recovers through its LOF are transaction costs, processing costs, and the brokerage commission paid to Taxpayer.

[Emphasis added.] Under Rule 229 when refund requests are initiated by a petition of a taxpayer, refunds are granted on a conditional basis and subject to future field audit verification. In this case, the evidence shows that in 1999, TAA issued a conditional refund to Taxpayer that specifically stated that it was subject to future verification by field audit. In January of 2001 Audit contacted Taxpayer and attempted to verify Taxpayer's credit request by examining Taxpayer's records. Audit determined that Taxpayer's refund exceeded the amount properly due and issued an assessment to recover the excess amount within the statute of limitation for imposing taxes. This procedure is specifically authorized by Rule 229. Therefore, we find no basis for Taxpayer's objection. Taxpayer's petition is denied on this issue.

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DECISION AND DISPOSITION

We deny Taxpayer's request for a deduction under RCW 82.04.4292. We deny Taxpayer's petition on yield spread premiums. We deny Taxpayer's estoppel argument. We grant Taxpayer's petition to exclude from income amounts retained by Mortgage for processing and transaction fees. Taxpayer's file shall be remanded to Audit for the proper adjustments consistent with this determination.

Dated this 14th day of April, 2003