Cite as Det. No. 99-241, 19 WTD 295 (2000)

BEFORE THE 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. 99-241
	)	
. . .	)	Registration No. . . .
	)	REQUEST FOR REFUND
	)	
	)	

[1] RULE 146; RCW 82.04.4292: B&O TAX-- REQUIREMENTS. The person claiming the B&O tax deduction under RCW 82.04.4292 must meet all five elements of the statute.

[2] RULE 146; RCW 82.04.4292: B&O TAX—MORTGAGE BROKERS. There are three types of mortgage brokers which the Department has classified as "pure mortgage brokers", "correspondent mortgage brokers", and "lending mortgage brokers".

[3] RULE 146; RCW 82.04.4292: B&O TAX—PURE MORTGAGE BROKERS. When the agreements between the mortgage broker and the financial business specify that loans funded by the financial business will be closed in the name of the financial business, the mortgage broker is acting as a pure mortgage broker. When a mortgage broker acts as a "pure mortgage broker", it is not entitled to the RCW 82.04.4292.

[4] RULE 146; RCW 82.04.4292: B&O TAX—CORRESPONDENT MORTGAGE BROKERS. When the agreements between the mortgage broker and the financial business specify that loans funded by the financial business will be closed in the name of the mortgage broker and the mortgage broker is required to assign the loan to the financial business, the mortgage broker is acting as a correspondent mortgage broker. When a mortgage broker acts as a "correspondent mortgage broker", it is not entitled to the RCW 82.04.4292.

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.

NATURE OF ACTION:

A mortgage broker protests the Department's denial of its request for a refund of business and occupation (B&O) taxes paid on loan fees retained and other income from first mortgages and deeds of trust on nontransient residential real property claiming RCW 82.04.4292 allows a deduction for this income. [1]

FACTS:

Coffman, A.L.J. -- The taxpayer is a licensed mortgage broker. Its primary business activity is assisting individuals in obtaining loans secured by mortgages or deeds of trust. In order to provide this service, the taxpayer has entered into agreements with several financial businesses. These agreements provide for the taxpayer to originate and sell loan applications and/or loans secured by nontransient residential real property.

On October 15, 1996, the taxpayer submitted to the Taxpayer Account Administration Division (TAA) of the Department of Revenue (Department) a request for refund of B&O taxes paid during the period January 1, 1992 through October 15, 1996. TAA referred the taxpayer's request to the Audit Division of the Department for verification of the amended excise tax returns attached to the refund request. The Audit Division referred the matter to the Appeals Division for resolution.

The Appeals Division provided the taxpayer with a copy of Det. No. 98-218, 18 WTD 46 (1999), which specifies the conditions under which the RCW 82.04.4292 deduction is available. The taxpayer provided the Appeals Division with copies of its agreements with various financial businesses for funding of the loans for taxpayer's customers. We have reviewed these agreements and determined that a telephone conference is not necessary to resolve the taxpayer's appeal. See WAC 458-20-100(4)(a).

Several of the agreements require the mortgage loans to be closed in the name of the financial business. For example,

> 1. "All loan packages shall close in the name of Lender, or its nominee."[2]
> 2. "All Loans shall be closed in [financial business'] name and on Loan documentation and in a manner approved by [financial business]."[3]
> 3. "Loan approval shall be within Banker's sole discretion. Broker shall not represent that Banker has approved or will approve any Loan until Broker is so informed by Banker in writing. All Loans shall close in Banker's name."[4]

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.
[2] ¶ 2.03 -- Agreement with . . . .
[3] ¶ 2 -- . . . Agreement with . . . .
[4] ¶ 2 -- Agreement with . . . .

Several other agreements provide that the financial business will "fund", make a loan to the taxpayer's customer, or purchase the loan application package from the taxpayer. For example,

> 1. "For each loan accepted by LENDER, LENDER shall fund the loan provided that all conditions precedent are satisfied and all documentation as required by LENDER are timely executed, acknowledged and returned to LENDER."[5]
> 2. "If the Application is approved and all conditions of approval, as contained in a loan commitment and escrow instructions, have been accepted by the Applicant and performed, Lender shall fund a loan to an Applicant as approved."[6]
> 3. "The decision to consummate a loan transaction or otherwise extend credit shall be within the sole discretion of the Bank; the Bank is not obligated to consummate a loan transaction or otherwise extend credit to any potential applicant for an Application submitted by Broker/Correspondent."[7]
> 4. [Financial business] "agrees to purchase and accept from [taxpayer] all of [taxpayer's] right, title and interest in and to certain one to four (1-4) family residential first and/or second mortgage loan applications originated and processed by [the taxpayer], then packaged and submitted to [financial business] for underwriting and possible funding.[8]

Some of the agreements require the loans to be closed in the taxpayer's name, but provide that the financial business will fund the loan. Examples of these agreements include

> 1. "[Financial business] is mortgage lender that accepts conventional, FHA and VA Mortgage Loan origination's [sic] (servicing released) from licensed mortgage brokers and enters into Table-funding arrangements with licensed originators . . . '**Table-funding**' means the practice where the Mortgage Loan is closed in the Mortgage Broker's name and assigned on the Closing Date to [financial business], which funds the Mortgage Loans."[9] (Emphasis in original.)
> 2. "[Financial business] shall fund each closed Loan in such fashion that the [taxpayer] shall not be required to use its own funds or warehouse lines of credit."[10]
> 3. "[Financial business] agrees to fund certain loans which are processed and packaged in Broker's name and submitted to [financial business] for approval and funding . . . [Financial business] agrees to fund all approved submissions in a timely manner upon issuance of a written commitment . . ."[11]

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[5] Page 1 -- Agreement with . . . .
[6] ¶ 2.02 -- Agreement with . . . .
[7] ¶ 11 -- Agreement with . . . .
[8] Recital -- Agreement with . . . . Note in this agreement the taxpayer is referred to as the lender, however, we will look to the substance of the transaction and not to the labels used in the agreement to determine the deductibility of income thereunder. Det. No. 98-218, supra.
[9] Preamble and § 1.1 -- Agreement with . . . .
[10] This language is found at both ¶ 3, -- Agreement with . . ., and ¶ 3 -- Agreement with . . . .
[11] Preamble and ¶ 4 – Agreement with . . . .

Additionally, several of the agreements provide for options such as:

1. All conventional loans will be closed in the name of the financial business and all VA and FHA loans will be closed in the name of the taxpayer and "concurrently assigned" to the financial business.[12]
2. "All loans will close in the name of the [financial business] with [financial business'] funds unless prior written approval was given to close the loan in the [taxpayer's] name, using the [financial business'] funds."[13]
3. "Broker will either close in [financial business'] name or close in Broker's name and immediately assign loan to [financial business] upon funding at closing."[14]

Every agreement provided by the taxpayer contains language specifying that the agreement does not create an agency relationship between the taxpayer and the financial business.[15] Further, most of the agreements specifically state that the parties are not partners nor engaged in a joint venture.

Every agreement contains requirements for the taxpayer to make certain covenants, representations, and/or warranties relating to each loan package. These covenants, representations, and/or warranties include, but are not limited to, the following items:

1. All documents included in the loan package are valid and genuine.
2. All loan packages are complete, true, and accurate.
3. The loan packages do not contain any fraudulent or intentionally misleading information.

Nineteen of the 24 agreements submitted by the taxpayer contain a provision requiring the taxpayer to "repurchase" the loans if there is a violation of the covenants, warranties, or representations. Four of the remaining agreements contain indemnification provisions in the event of fraud or misrepresentation. The copy of the final agreement is missing several pages and we are unable to determine if it contains the "repurchase" provision.

ISSUE:

Whether the taxpayer's receipt of fees relating to loans on nontransient residential real property constitutes interest.

DISCUSSION:

We begin with basic principals of tax law. 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

[12] See ¶ VI Agreement with . . . and ¶ III FHA/VA Addendum to Broker Agreement.
[13] § III – Agreement with . . . .
[14] ¶ 2(b) – Agreement with . . . .
[15] Some agreements contain language specifying that the taxpayer is the agent for the financial business for the limited purpose of ordering appraisals or holding interest rate lock fees.

764 (1972). Thus, "the burden of showing qualification for the tax benefit afforded likewise rests with the taxpayer." Group Health Co-op. v. Tax Comm'n, 72 Wn.2d 422, 429, 433 P.2d 201 (1967).

1. **Deductibility of loan fees.**

The taxpayer claims its receipt of fees related to loans it brokers is deductible from the measure of the B&O tax under RCW 82.04.4292, which states:

> 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.

[1.] The Department recently published Det. No. 98-218, supra, which specifies the tests the Department uses to determine if a receipt is deductible under RCW 82.04.4292. Specifically, we held:

> The test for qualifying fees is summarized as follows:
>
> A. The taxpayer must be 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 forebearance 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 retains the risk of interest rate fluctuations.
> D. The loan or investment is primarily secured by a first mortgage or deed of trust; and
> E. The first mortgage or deed of trust is on nontransient residential real property.

[2.] As stated in Det. No. 98-218, supra, there are generally three types of mortgage brokers. Specifically, these include (1) "pure mortgage brokers", (2) "correspondent mortgage brokers",

and (3) "lending mortgage brokers".[16] For the purposes of this determination it is necessary to consider only the first two types of mortgage broker activities. We analyzed the pure mortgage broker activity as follows:

> For those loans where the taxpayer acts solely as a broker, the taxpayer meets with a potential borrower and obtains financial information from the borrower. The borrower deposits a specified sum with the taxpayer to use to pay third-party costs, arising out of the transaction. This payment is placed in a trust account pursuant to RCW 19.146.050.[17] After obtaining the necessary information from the potential borrower, the taxpayer prepares the loan application and "shops" the application with potential lenders. If the application is accepted by a lender and the loan closes, the taxpayer receives a fee for these services. The fee is usually designated as a "loan origination fee".
>
> We look to the substance of the fee, not merely the label placed on it. Det. No. 89-280, supra, and Det. No. 90-141, supra. When the taxpayer acts as a pure mortgage broker, the taxpayer is receiving a fee for obtaining the loan for the borrower. This brokerage fee is indistinguishable from a finder's fee, which the courts in Duffy v. The United States, supra, and Lincoln v. Transamerica Investment, supra, said was not interest. See also Det. No. 89-280, supra, in which we also held a similar finder's fee was not interest. Thus, the LOF in the pure mortgage broker scenario fails the second element of the RCW 82.04.4292 deduction.
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> Further, the taxpayer is not the party granting the right to use money. The taxpayer bears none of the risk of an interest rate decline. Therefore, the taxpayer's receipt of a LOF in this type of transaction also fails to meet the third element under RCW 82.04.4292, that is, the LOF is not derived from the taxpayer's investment or loan. The RCW 82.04.4292 deduction is not available to the taxpayer in pure mortgage broker situations.[18]

(Footnote in original.)

[3.] The loans that close in the name of the financial business are the result of the taxpayer's "pure mortgage broker" activity. Therefore, the compensation the taxpayer receives from this activity is not deductible under RCW 82.04.4292.

Det. No. 98-218, supra, also described the "correspondent broker" activity and analyzed it as follows:

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[16] The label used by the taxpayer to identify its relationship with the borrower and/or the ultimate lender does not determine the classification of the taxpayer's activities. It is the substance of the activities that is important. Det. No. 98-218, supra.

[17] These amounts are not taxable to the taxpayer pursuant to Det. No. 92-393, 12 WTD 253 (1993) and Det. No. 94-92, supra.

[18] See also FASB 65 ¶ 24, which treats fees paid to pure mortgage brokers as "loan placement fees".

> Again, we must look to the substance of the transaction and not merely its form. In these transactions, the taxpayer is identified on the closing documents as the lender. Thus, it appears the taxpayer has granted to the borrower the right to use money. However, the taxpayer is obligated to transfer the loan to, or on behalf of, the same lender who advanced it the funds. In these situations, we find the taxpayer was merely the agent for the lender and, as such, the taxpayer does not bear the risk of interest rate fluctuations.
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> The Washington Supreme Court said: "Agency requires that both parties consent to the relationship and that the principal exercises control over the agent." Nordstrom Credit, Inc., supra, at 941. The agreements between correspondent brokers and correspondent banks show there is consent by both parties.
>
> Further, the correspondent bank only funds those loans it has previously approved. The correspondent broker must comply with the correspondent bank's guidelines and may not close the loans without prior approval. This constitutes sufficient control by the correspondent bank over the correspondent broker to establish that the correspondent broker acts only as the agent for the correspondent bank.
>
> [12] The correspondent broker is not the true lender of funds to the borrower; rather, the correspondent bank is the true lender. The correspondent bank bears the risk of interest rate fluctuations and is entitled to receive repayment of the principle of the loan. The correspondent broker is not entitled the repayment of the principal and bears no risk of interest rate fluctuation. The correspondent broker is taxable in the same manner as the pure mortgage broker discussed above. Any fee it retains is neither interest nor derived from its investment and not deductible under RCW 82.04.4292.

[4.] While the agreements between the parties state there is no agency relationship between the taxpayer and the financial business, the control exercised by the financial business over the activities of the taxpayer in relation to each loan funded by the financial business demonstrates the existence of an agency relationship. The taxpayer may not be generally an agent of the financial business before the financial business agrees to fund the loan. However, once the financial business makes the commitment to fund the loan, the financial business controls the taxpayer as to how the loan is to be closed and the submission of the documents to the financial business.

Further, the taxpayer does not have any risk that interest rates may fluctuate. Therefore, where the agreements state the financial business will fund the loan, the taxpayer operated as a correspondent broker and is not entitled to the RCW 82.04.4292 deduction.

Our review of the agreements provided by the taxpayer does not disclose any instance in which the taxpayer acted as a "lending broker".

DECISION AND DISPOSITION:

The taxpayer's request for a refund of B&O taxes is denied.

Dated this 16th day of July 1999.