Cite as Det. No. 90-141, 9 WTD 280-29 (1990)

THIS DETERMINATION HAS BEEN OVERRULED OR MODIFIED IN WHOLE OR PART BY DET. NO. 98-218, 18 WTD 46 (1999)

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	)	
	)	Det. No. 90-141
	)	
. . .	)	
	)	Registration No. . . .
	)	Documents Nos. . . .
	)	

[1] **RULES 109 and 146:** B&O TAX - INTEREST - SALE OF LOAN - "RETAINED INTEREST" - INTEREST V. PREMIUM. Only the owner of a first mortgage home loan may report and then deduct interest received on that loan. If the entire loan is sold to another, only the new owner may report and deduct the interest received, since only the new owner's money is being used by the borrower (the "old" owner having been repaid by the "new" owner). If an element of interest is retained by the seller of a loan as a result of the contract of sale between the old and new owner - even though no portion of the loan has been retained by the old owner - that interest is a premium properly taxable as a gain. When only a portion of a loan is sold, interest received attributable to the retained portion may be properly deducted by the owner of that retained portion.

[2] **RULE 162 and RCW 82.04.080:** B&O TAX - FINANCIAL BUSINESS - INTEREST RATE HEDGING - FUTURES CONTRACTS -GAINS REALIZED. Futures contracts used by financial businesses for interest rate hedging purposes are taxable measured by the gains realized from trading. Such gains are reportable on a monthly basis.

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: September 19, 1989

NATURE OF ACTION:

Petition concerning the taxability of retained interest elements on the sale of loans, and the taxability of futures "hedging" contracts.

FACTS:

Bauer, A.L.J.-- The taxpayer's business records were examined for the period . . . through . . . . The above-referenced assessments were respectively issued on . . . and . . . in the amounts of $ . . . and $ . . . . Of these amounts, the taxpayer has already paid $. . . .

The taxpayer is a savings and loan association which made first mortgage home loans to its customers. These loans were "pooled" and sold in the secondary mortgage market - at par - to federal mortgage-backed guarantee programs such as GNMA, FNMA, and FHLMC. Investors could then purchase federal mortgage-backed certificates in these pools. As part of the agreement, the taxpayer retained the servicing responsibility in exchange for a small amount of the interest to be collected from the homeowner, which percentage was established by industry practice.[1]

Normally, one hundred percent of each loan was sold. In the atypical case, the taxpayer retained a portion of the loan (such as 5%) and sold the remainder (95%).[2] The loans (or portions thereof) were sold at a specified yield (generally, the secondary mortgage market rate) to the buyer, which yield was normally lower than that interest which the homeowner had agreed to pay to the taxpayer. In order to adjust the interest rate payable to the buyer, the taxpayer carved out and retained a portion of the income stream as it was received. The taxpayer, as servicer, would thus collect the full interest rate on the loan paid by the homeowner, and then pass the investors yield to them, retaining the difference. The tax treatment of this retained amount[3] is at issue.

In accordance with required accounting procedures, the present value of the interest differential was required to be booked by the taxpayer at the time of the sale of the loan in its "Premium on Loan Sale" account. This premium was then amortized on the taxpayer's books over the expected life of the loan.

The taxpayer reported the accelerated interest amount and deducted that amount when the loan was sold. The taxpayer then adjusted both the income and the deduction if the loan terminated before its

[1] The taxpayer states that the current industry norm for servicing fixed-rate loans, the only type sold by the taxpayer, is 1/4 to 3/8 of one percent.

[2] The taxpayer claims that in certain cases this might be done because it is what the marketplace is looking for, or a retained interest in the principal amount might serve as better incentive for the servicer. In any case, a retained portion of the principal amount of the loan is not the norm.

[3] Minus the servicing fee, on which the taxpayer has already paid tax.

expected life was completed. This treatment was consistent with external reporting, because the amounts were included in the taxpayer's income statement when accelerated and then subsequently upon making any adjustments.[4] The auditor disallowed the deductions and taxed those amounts in the taxpayer's "Premium on Loan Sale" account as gains from the sales of the loans.

In addition, the auditor disallowed the taxpayer's losses from futures transactions included in its netting of trading gains and losses under WAC 458-20-162, and asserted service tax on the gains. In so doing, the auditor looked at the following records:

> 1) Investment ledgers which show the investment amount, yield, and the discount or premium at the time a bond or security is purchased. They also show the amount of futures sold and the amount of gains and losses when same were repurchased and finally the gain or loss when the hedged assets (bonds or securities) are sold.
>
> 2) Journal entry vouchers which show the entries relating to the purchase of the hedged bonds and securities, premiums and discounts, sale and repurchase of futures, margin deposits, daily settlements with the broker, futures gains and losses at the time the futures contract is closed out, and the gains and losses when the hedged asset - bonds and securities are sold.
>
> 3) A schedule of amortization of premiums and discounts.
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> An examination of these records revealed that a loss from sales of futures contracts were either used as an offset to gains when the hedged bonds or securities were sold, or the loss was amortized and included as an increase to premium or as a decrease to discounts on hedged bonds that were outstanding.

[Auditor's Detail of Differences and Instructions to Taxpayer, p.2, January 19, 1988.][5]

The transactions at issue had been entered into for hedging - as opposed to speculative - purposes.

ISSUES AND TAXPAYER'S EXCEPTIONS:

RETAINED INTEREST. The taxpayer first contends that the interest differential it retained on the sale of its mortgages in the federal secondary mortgage market - reflected in its "Premium on Loan Sale" account - were properly deductible as interest derived from first mortgages on nontransient housing, and not taxable as a trading gain.

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[4] Although reporting and deducting the interest differentials as received has not been the taxpayer's past practice, the taxpayer would not be adverse to doing so in the future.

[5] The taxpayer notes that this description omits to state that futures gains are used in the same ways - as an addition to gains when the security is sold or amortized as a decrease to premium or as an increase to discounts. Thus, while the audit report is not incorrect, it provides only a partial view of how the futures activity works.

The taxpayer contends that it remained a lender to its customer (the homeowner) with respect to the retained portion of the income stream on that particular loan. The taxpayer points out that the "Premium on Loan Sale" account merely reflected the present value of one portion of the interest which was to be received from the taxpayer's borrower (the homeowner). It was not received from the purchaser of the loan. As the taxpayer's comptroller explained to the auditor, these amounts were not excess proceeds received from the buyer of the loan, even though the required bookkeeping entries might have made them appear as such. The taxpayer's being required to book the present value of the interest differential in a lump sum account might have made them appear to be so.

The taxpayer argues that the proper focus is, "Where did the taxpayer get the right to receive the interest?" The investor hasn't actually given anything in return to the taxpayer for that retained portion. The premium merely represents what will be received from the taxpayer's borrower.

The taxpayer further contends that the fact that this amount was taxed at all was simply "an accident of reporting" in that it never would have appeared in the books at all except for accounting requirements that it be booked as a lump sum.

As support for its position that it receives this income as a lender rather than as the seller of the loan, the taxpayer states that it has the right to recover any accrued interest owing to it from either foreclosure sale proceeds or casualty insurance proceeds, on a ratable basis. If these proceeds are insufficient to cover the interest owing to the taxpayer, the taxpayer has no claim against the purchaser of the loan for the balance.

Further, the taxpayer cites Weyerhauser Co. v. Department of Revenue, 106 W.2d 557 (1986) as controlling. In Weyerhauser, the court held that under RCW 82.04.270 and .290, and implementing regulations, which provided for an excise tax on wholesaling at a rate different from the tax rate on interest, a wholesale installment sales contract which did not provide for interest was not subject to an imputation of interest for excise tax purposes, and the fact that the wholesaler computed an interest component of the sale for its internal bookkeeping did not justify the State's imputation of interest for tax purposes.

The taxpayer additionally cites the Department's recent determinations regarding loan fees, wherein it has been held that the Department will consider the substance of the fees charges - and not only the labels given them - to determine their deductibility. Thus, loan origination fees which relate to loans primarily secured by first mortgages or deeds of trust on nontransient residential property, and which are based on a percentage of the principal amount and represent an interest yield adjustment charged on loans have been held deductible under RCW 82.04.4292.

Lastly, the taxpayer points out that the interest differential received was still in the loan stream, and that the taxpayer and homeowner still maintained a continuing debtor/creditor relationship with the homeowner which had not been discharged by the selling of the mortgage.

FUTURES. The taxpayer argues that hedging transactions involving futures contracts were incorrectly taxed by the auditor.
A futures contract is a legal agreement between a buyer or seller and the clearing house of a national futures exchange. The agreement obligates the purchaser to accept and the seller to make delivery of a standard quantity of a commodity or financial instrument on certain terms at a specified date or during a specified period, or provide for cash settlement rather than delivery. A futures contract can effectively be cancelled before the delivery date by entering into an offsetting contract for the same commodity or financial instrument. Changes in value of open contracts are settled on a regular basis, usually daily, in order to reflect the change in the value of the contract.

The taxpayer explains that numerous financial institutions engage in futures contract transactions in order to hedge risks which are associated with changes in interest rates. They use the futures market to stabilize or ensure a margin of profitability in their investments by locking in interest rates on the liability side and/or protecting themselves against declines in asset values as interest rates increase. The purpose and effect of these futures contracts is to hedge interest rate exposure, rather than to generate income from trading.[6]

The taxpayer in this case entered into futures contracts in order to hedge the interest rate risk inherent in specific long-term investments. Each futures contract was matched to a specific investment in order to maintain the investment's value. For example, the taxpayer would purchase a U.S Treasury note for a given amount. If interest rates were to rise, the value of the note would fall as its interest rate dropped below market. Conversely, the value of the note would rise if market interest rates were to fall. The futures contracts, usually of three months' duration, had the effect of stabilizing the value of the specific asset, because the value of the futures contract would change in the opposite direction from the hedged asset in response to market rate changes.

The taxpayer argues that, just as the initial purchase is an economic "input" required for acquisition of the asset, so are the futures contracts. The taxpayer desired to own a bond or note of a given size, value, and return. To do so, it had to expend a purchase price and enter into matching futures contracts.

The taxpayer urges that because these hedges were thus an expense-related activity, they are nontaxable under the business and occupation tax statutes. They affect only the taxpayer's expenses (and therefore the margin) associated with its investing activity. The taxpayer states that it does not enter into futures contracts for an independent purpose or to generate income. Instead, it claims that the futures contracts are an essential, integral part of the investment activity as conducted by it, as a cost of supporting the value of the specific original investments.

[6] Additionally, futures may be traded on a speculative basis to obtain a profit. The principal force driving the futures contract trading market is the fact that futures contracts have a value that goes up or down as current market interest rates, and the prices of the underlying securities, change. The taxpayer did not engage in such trading during the audit period.

The taxpayer further likens the transactions to insurance against the risk that current market conditions will not stay the same. The proceeds of insurance do not constitute taxable gross income.

Therefore, financial hedges do not generate gross income as understood in Chapter 82.04 RCW, but instead have only a positive or negative effect on the cost of doing business.

Although the taxpayer presses the argument that futures transactions are not taxable at all, it has offered to forego pursuing it with respect to "matched" futures contracts if the Department agrees to impose tax only on the net proceeds - the "gains realized" - derived from such transactions. The taxpayer has thus proposed the following:

The economic purpose and impact of hedging long-term assets with futures contracts is to maintain the long-term value of the asset over one or more cycles of interest rate changes. Taxing the "gains" from futures contracts on a separate schedule from the hedged assets would therefore involve a misstatement of the actual impact of the futures, because it would reflect only one-half of the impact on the taxpayer's financial position. A series of futures is "matched" to the investment over its entire term, and they are viewed as essential to the investment activity itself. Because these two aspects of the activity are integrated, the "gains realized" from the "transaction of the business engaged in" should not be taxable until the entire transaction is closed by disposition of the security.

As the Department has recognized in Final Determination No. 83-339A, page 5, the definition of "gross income of the business" "clearly contemplates that it is the total business transaction which determines the gain realized, not some bifurcated segment thereof." The futures contracts are an integral part of the taxpayer's business, so their impact on the "gain" or "loss" on the investment should be recognized only upon disposition of the investment.

DISCUSSION:

RETAINED INTEREST. The taxpayer has strenuously argued that the interest element it has retained in the mortgages it has sold on the federal secondary mortgage market is deductible "interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties." WAC 458-20-146. We disagree, with one qualification.

The Revenue Act of this State does not define the term "interest." The Supreme Court of Washington in Security Savings Society v. Spokane County, 111 Wash. 35 (1920) discussed a legislative change in the rate of interest applicable to delinquent taxes, and in so doing noted that,

> Interest is merely a charge for the use or forbearance[7] of money. In such case as this it has the character of both a penalty and an interest charge.

[7] **FORBEARANCE.** Act by which creditor waits for payment of debt due him by debtor after it becomes due.... A delay in enforcing rights.... Indulgence granted to a debtor.... Refraining form action.... (Black's Law Dictionary 3d Edition 1968, citations omitted.)

The "retained interest element" - booked by the taxpayer in its "Premium on Loan Sale" account at present day value - did not reflect a charge for the use or forbearance of the taxpayer's money. The money the taxpayer had originally loaned was "repaid" when the loan was sold at par, at which time the homeowner was then using the money of the new owner of the loan. The fact that - as a result of the sale of the loan - the new owner had agreed to receive less interest for the use of its money than the taxpayer had originally negotiated, and the fact that the taxpayer was to retain part of the original interest stream from the homeowner, does not change this result. The accounting requirement that this retained interest element be booked as a premium instead of interest merely reflected this financial reality.

We have considered the taxpayer's arguments regarding Weyerhauser and our own Departmental determinations regarding loan fees, and do not find them apposite. We are not imputing a gain where none existed - the taxpayer's own accounting requirements reflected this. Further, we are in fact looking to the substance of these transactions, as our loan fee determinations require. The taxpayer, having sold a loan in its entirety, has - by virtue of the sale - retained an income interest in it over and above the amount it had originally invested in it. Such amount received on the sale of an instrument over and above the taxpayer's original investment is properly categorized as a gain.

[1] Only the owner of a first mortgage home loan may report and then deduct interest received on that loan. If the entire loan is sold to another, only the new owner may report and deduct the interest received, since only the new owner's money is being used by the borrower (the "old" owner having been repaid by the "new" owner). If an element of interest is retained by the seller of a loan as a result of the contract of sale between the old and new owner - even though no portion of the loan has been retained by the old owner - that interest is a premium properly taxable as a gain. It then follows that, when only a portion of a loan is sold, interest received attributable to the retained portion may be properly deducted by the owner of that retained portion.

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

As to the futures issue, in accordance with recently published Final Determination 90-63, __WTD__, 23 (1990), the following has been held to apply:

> Unlike interest rate swaps, it is unnecessary to distinguish between the reporting methods for "matched" futures contracts used for hedging purposes and futures trading. Futures trading is ordinarily conducted at a very rapid pace in circumstances very much like trading in securities. Futures contracts for hedging purposes, on the other hand, are settled in cash on a daily basis, as if the instrument had been sold at its fair market value as of the close of trading, in exactly the same fashion as a completed exchange of the instrument. In either case, the taxpayers should report gains, calculated pursuant to WAC 458-20-162, as gross income in the earnings account entitled "Trading."

[2] Accordingly, futures contracts used by financial businesses for interest rate hedging purposes are taxable measured by the gains realized from trading. Such gains are reportable on a monthly basis.

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

DECISION AND DISPOSITION:

The taxpayer's petition for correction of assessment is granted in part and denied in part.

DATED this the 28th day of March 1990.