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BEFORE THE DIRECTOR
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition)
for Interpretive Ruling of:)
. . .)
. . .)
. . .)
. . .)

F I N A L D E T E R M I N A T I O N

No. 90-63

Taxpayers Represented By: . . .
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Department of Revenue Represented By:

Conference on October 12, 1988, Olympia, Washington:

Steve Frisch, Acting Director
Matthew J. Coyle, Former Deputy Director
Garry G. Fujita, Former Assistant Director, I&A Division
Edward L. Faker, Former Senior

Administrative Law Judge

Conference on August 14, 1989, Olympia, Washington:

Sandi Swarthout, Deputy Director
Edward L. Faker, Assistant
Director, I&A Division

[1] RCW 82.04.080 -- RULE 162: FINANCIAL BUSINESS INTEREST RATE SWAPS -- FUTURES CONTRACTS -- INTERMEDIATED SWAPS -- MATCHED INTEREST RATE SWAPS -- VALUE PROCEEDING OR ACCRUING -- GAINS REALIZED. Financial businesses engage in interest rate hedging transactions, including intermediated or matched interest rate swaps and interest rate futures contracts are taxable upon the value proceeding or accruing from such transactions as determined by the interest gains realized when the swap is closed on a monthly reporting basis.

[2] RCW 82.04.080 -- RULE 162: 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.

[3] RCW 82.04.080 -- RULE 162: INTEREST RATE HEDGING PROGRAMS -- ONGOING INTEREST RATE SWAPS -- VALUE PROCEEDING OR ACCRUING -- GAINS REALIZED -- TAX REPORTING METHODS. Financial businesses which engage in ongoing programs of hedging against interest rates risk through the continuous swapping of rates are engaged in district and taxable financial business activities taxable upon the gross receipts of such activity determined by gains realized. Tax is to be measured by the annualized monthly average of gains and losses during the accounting year of the business.

This legal opinion may be relied upon for reporting purposes and as support of the reporting method in the event of an audit. This ruling is issued pursuant to WAC 458-20-100(18) and is based upon only the facts that were disclosed by the taxpayers. In this regard the department has no obligation to ascertain whether the taxpayers have revealed all of the relevant facts or whether the facts disclosed were actually true. This legal opinion shall bind taxpayers and the department upon those facts.

However, it shall not be binding if there are relevant facts which are in existence but not disclosed at the time this opinion was issued; if, subsequently, the disclosed facts are ultimately determined to be false; or if the facts as disclosed subsequently change and no new opinion has been issued which takes into consideration those changes. This opinion may be rescinded or revoked in the future, however, any such rescission or revocation shall not affect prior liability and shall have a prospective application only.[1]

NATURE OF ACTION

The petitioners are three national banking associations and one state bank engaged in Washington in full-service commercial banking. They have sought the Department's interpretation of the proper taxation of certain financial business activities that have developed in the last decade that are not expressly addressed in the business and occupation ("B&O") tax statutes or regulations.

Because the taxpayers' petition in this case does not relate to a specific audit assessment (the Department is not relying on any recent audits of the petitioners' records), the taxpayers' factual descriptions of the transactions at issue are taken as stipulations. The legal conclusions reached in this Determination are limited in their application to the transactions as described.

The legal issues presented by the taxpayers concern transactions involving financial instruments or obligations

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[1]We have incorporated significant portions of the taxpayers' petition on the facts, some of the arguments and some proposed solutions, in narrative form, at length in this Determination, only for purposes of presenting the facts, issues, and conclusions in a thorough and relevant manner.

The department does not guarantee the precision or validity of all presentations made regarding the financial transactions and theories referred to, in general or by example.

(swaps and futures) that do not constitute securities as traditionally understood. The taxpayers have asked the Department to rule on whether these transactions should nevertheless be treated in a manner similar to trading in securities and whether, if the transactions are engaged in for the purpose of hedging, they should be taxed at all. These transactions and the taxpayers' view of their tax consequences are described in turn below.

FACTS

The taxpayer-petitioners explain the facts of this matter as follows. Since the deregulation of interest rates in the 1970s, the petitioners and the entire financial industry have felt an enormous impact from the resulting high degree of interest-rate volatility. In order to continue their traditional business of offering long-term, fixed-rate loans and deposits to the public, petitioners and other banks have been forced to insure against and reduce their exposure to interest rate changes. They have done so by relying on new instruments and hedging activities, such as interest rate swaps and interest rate futures contracts.

The new volatility of interest rates has also opened a new opportunity for profit-making activity by arranging the hedging activities desired by others and by trading in these instruments. In addition to banks similar in size to the petitioners, many other businesses in the state, such as smaller banks, securities houses and "broker-dealers," and nonfinancial businesses, engage in some of these activities.

The petitioners claim that these activities involve an enormous flow of cash but a tiny margin of profit, if any. The petitioners have therefore requested from the Department a legal interpretation of how the B&O statutes apply to these transactions so that they may better calculate their economic costs and determine at an early date whether to continue to conduct these activities in Washington.

DEPARTMENT'S CURRENT POSITION

The taxpayers' petition was submitted against the background of Final Determination No. 85-117B, issued to one of the taxpayer- petitioner banks on December 12, 1986. The Final

Determination affirmed Determination No. 85-117. The Department's Determinations principally addressed the taxpayer's arguments that its interest rate swap and futures transactions were not taxable. The Department's comments ranged beyond the transactions at issue, however, and are currently being cited by auditors in their analysis of other taxpayers' obligations.

In the audit then under review, the taxpayer bank was found to have engaged in a limited number of interest rate futures contract transactions and one interest rate swap. All of these transactions were conducted in order to "hedge" or control interest rate expenses related to funding banking operations. The auditor determined that the futures transactions were taxable on the gains under W.A.C. 458-20-162 and that the swap transaction was taxable on the gross amounts received.

The Administrative Law Judge ("ALJ") concluded that both types of transactions were taxable business activities. His reasoning was that both types of transactions yielded "benefit or advantage" to the taxpayer and therefore constituted "business" activities under RCW 82.04.140, and that any value proceeding or accruing from the transaction of the "business" constituted "gross income of the business" under RCW 82.04.080. Such "gross income" was subject to tax. The ALJ therefore upheld the audit assessment, but expressed some reservations about the auditor's treatment of futures transactions.

> Incidentally, on the basis of the taxpayer's explanation of futures contract transactions, we are not altogether certain that this activity constitutes "trading in stocks, bonds, or other evidences of indebtedness" within the meaning of RCW 82.04.080. Thus, we would not necessarily allow futures contract losses as a deduction from or offset against trading gains if we were ruling on that precise question in the first instance.

(Determination No. 85-117, at 33).

Similarly, after ruling that interest rate swaps are taxable, the ALJ declined to accept the secondary argument that interest rate swap outlays should be offset against swap proceeds to arrive at a taxable "gain" on analogy to Rule 162. The reason was that interest rate swaps "do not, in fact, involve 'trading in stocks, bonds, or other evidences of indebtedness'." Id. at 34.

In Final Determination No. 85-117B, the Department addressed itself principally to the argument that the hedging purpose of these transactions (i.e., to control interest expense) meant that they were not taxable. The Department disagreed, stating:

> We find no basis at law or otherwise for excluding the amounts derived from the appropriate Service business tax measure. . . . Amounts derived from futures contracts and interest rate swaps, regardless of their purpose, constitute a part of a bank's taxable gross receipts.
>
> Id. at 14 (emphasis added).

Thus, while the Final Determination denied the appeal, it did not reach an express conclusion about the appropriate measure of "gross income" from these types of transactions.

TAXPAYERS' EXCEPTIONS

A. Introduction.

Before the first conference, (October 12, 1988), the taxpayers provided the Department with a comprehensive memorandum dated August 31, 1988, concerning the taxation of interest rate swaps. At the conference, interest rate futures were also discussed, and the Department has received submissions concerning these types of transactions from other taxpayers whose audits are under appeal. The taxpayers have also presented additional information at the second conference, (August 14, 1989), concerning recent developments in complex hedge activity. All of these presentations are taken into account in this Determination, though it is acknowledged that the petitioning taxpayers are not responsible for the arguments submitted by other parties.

B. <u>Transactions in New Financial Instruments</u>.

1. <u>The Instruments</u>.

a. <u>Interest Rate Swaps</u>.

An interest rate swap is an agreement between two parties to pay each other over time amounts indexed to interest rates that exist in the marketplace. The standard agreement specifies:

(1) the hypothetical principal amount on which the periodic payments are calculated, which is sometimes referred to as the "notional" principal;

(2) the maturity or term of the swap;

(3) the timing of the payments;

(4) the benchmark interest rate indices (or a specified, fixed rate of interest, if applicable) that will be used to calculate the payments to be made by each party to the other; and

(5) the remedies in case of default.

Under such an agreement, the two parties promise to pay each other amounts computed using the notional principal amount and the specified benchmark interest rate indices, at specified periods. The most common index is Libor (London Inter-bank Offering Rate), but it can be prime, Treasury bill, or virtually any other rate. Where the exchange is based on a variable rate on one side and a fixed rate on the other, the swap is called a "plain vanilla" swap. Where the exchange is a variable interest rate on one side and a different variable rate on the other, the swap is called a "basis" swap.
Normally, the periodic payments of the two counterparties are settled on a net basis, although in some cases gross payments are made by both parties.

(i) <u>Purposes</u>.

The taxpayers engage in interest rate swaps for two basic purposes. The first purpose is "hedging" (<u>i.e</u>., regulating or stabilizing) the taxpayer's own interest expenses. The second purpose is to "intermediate" swaps, as a broker, between two parties that wish to regulate their interest expenses through an interest rate swap.

(ii) Swaps for Hedging Purposes.

In a swap for hedging purposes, a party enters into an interest rate swap that produces cash flows (payments from the counterparty) that will regulate or stabilize its net interest margin on a particular banking activity, such as a loan. The swap thereby reduces the taxpayer's interest rate risk exposure.

(A) Simple Example: Swap "Matched" to Underlying Funding Liability.

As an example, assume that a bank is asked to make a $10,000,000 fixed-rate loan to a customer with repayment over five years. The agreed rate is 10.00%. Because of market conditions, the bank's funding for the loan can only be drawn from one-year certificates of deposit. The certificates currently being sold bear interest at 8.00%, so the bank can expect a net interest margin of 2.00% for the first year.

Without hedging its interest rate exposure, however, the bank is at risk if rates rise. Every year the bank would need to sell a new set of C.D.s to redeem the expiring set and thereby maintain the funding of the fixed-rate loan. If rates were to rise in subsequent years, the bank would pay an increased rate on the C.D.s (i.e., its interest expense would increase) while the rate it would receive on the loan would stay the same. The net interest margin could be squeezed and could indeed become negative while the gross receipts from the lending side of the transaction would remain the same.

This exposure can be "hedged"--and the interest expense controlled--by entering into a long-term interest rate swap. Suppose the bank ("Bank A") enters into an interest rate swap contract with another bank ("Bank X" - usually a large, international commercial or investment bank) in which Bank A agrees to pay Bank X a fixed rate of 8.50% interest on a "notional" principal amount of $10,000,000 and agrees to receive from Bank X the rate at which one-year C.D.s are paid (currently 8.00%). Suppose also that the C.D. rate floats to 7.50% for year two, to 8.25% for year three, to 10.20% for year four, and to 9.30% for year five. A graph representing this transaction was supplied by the taxpayers and has been appended to the end of this Determination as Appendix I.

In this scenario, Bank A has "locked into" an interest expense of 8.50% on $10,000,000 for five years. Its margin will be 1.50% throughout the term of the loan. It has effectively eliminated its exposure to interest rate changes, although it has also foregone the possibility of profiting from those changes. In the first three years of the loan, it would appear that Bank A had controlled its interest expense in a disadvantageous way, because in each of those years the floating-rate liability it had given up was less than its actual fixed-rate liability. In the last two years, however, the adjustment of interest expense achieved through the swap worked to Bank A's advantage.

The end result of combining the sale of C.D.s with an interest rate swap is a constant interest expense and a fixed net interest margin, and this is true whether or not the swap of interest liabilities had the effect of raising or lowering Bank A's costs of funding the loan. Whether the swap resulted in a net "savings" or "dissavings" of interest expense is irrelevant to the business purpose. The taxpayers have indicated that, without the option of hedging interest expenses in this way, the ability of financial institutions to offer the public fixed-rate loans would be severely crippled.

In the jargon of the trade, this transaction is a "matched swap" for Bank A because the swap is tied to an underlying liability, and the two facets of the bank's expenses are integrated for accounting purposes. That is, generally accepted accounting principles require that the "interest" payments exchanged by Banks A and X be classified as the interest expense chargeable to Bank A's loan over the life of the loan. This is appropriate treatment, because the exchange of obligations is in most cases for a period of three years or longer. Bank A is interested in locking-in its net interest margin on the loan. The swap will achieve this purpose by fixing or locking-in the Bank's expenses. (The Bank's expenses will be equal to the cost of the underlying funding source, offset by the swap.) Whether the net impact on interest expenses is positive or negative cannot be determined until the swap's completion.

(B) Continuous Hedge Programs.

While the illustration of a "matched swap" in the previous subsection accurately describes the swap activity of financial institutions and business organizations whose hedging needs correspond to isolated transactions, it does not describe the scope and complexity of some hedging programs conducted by at least one of the taxpayers and other larger financial institutions.

The Department understands that the swap market is now of sufficient size and sophistication to permit large institutions to conduct a program of hedging interest rates in which
virtually none of the swaps are perfectly "matched" with a specific underlying liability. Instead, for example, the bank may be able to match the underlying funding liability with a swap for only part of its term, but the risk is low that the bank will be unable at a later time to rearrange or enter into new swap positions to cover the interest rate exposure. Or perhaps several swaps will be required to match the funding requirement with an equal amount of notional principal. That is, it is not necessary to match a single swap to the underlying liability, because the swap market contains a sufficient variety of opportunities to meet the bank's hedging requirement.

Given the flexibility of the market, major institutions are able to aggregate their hedging requirements for a broad spectrum of banking activities. These requirements will be at various volumes at various interest rates or indices. The banks can then engage in interest rate swaps that are not matched to specific liabilities but that in total satisfy their hedging requirements. Thus, the swaps used to satisfy these requirements are in a continual process of expiration and replacement unrelated to the terms of any loan or its funding sources.

When a bank conducts a coordinated, generalized program of hedging of this type, the "interest" payments exchanged in each swap are not accounted for as the interest expense chargeable to any particular loan. Rather, the payments exchanged in all such swaps are classified together for accounting purposes in an interest expense account.

(iii) Intermediated Swaps.

Because many corporations and smaller banks find themselves in a position where hedging their interest costs is both necessary and desirable, larger banks are in a position to arrange swaps for them and to make a profit on the transaction. These arrangements take a variety of forms, the most common being (1) the "matched book" intermediated swap, where the larger bank stands in the middle between counterparties, each of whom desires to pay the type of rate being paid by the other, and (2) the "hedged" intermediated swap, where the larger bank "matches" an interest rate swap on one side with interest rate futures contracts on the other (rather than a second, complementary swap). Some of the taxpayers engage in these types of swaps as well as the hedging swaps described in the previous section, with which they hedge their own costs.

Customarily, the intermediary bank will set up one leg of the transaction and then attempt to find a corresponding party for the reverse position (the other "counterparty"). This approach enables the middleman to quote terms and execute swaps virtually with a phone call, if the preliminary paperwork has been largely completed. A bank's position as intermediary in an intermediated swap can now be offset on a rapidly developing secondary market, which is a pool of potential counterparties for such offsetting swaps. Because the swap is an asset and the position can be traded, banks are required to revalue their intermediated swaps to market value ("mark-to-market") periodically, just as they revalue securities inventory to market value.

As with other swaps, the periodic payments of the two counterparties to an intermediated swap usually are settled on a net basis, by the intermediating bank. In some cases, gross payments are made to the intermediary and immediately passed through to the two counterparties. The intermediating bank earns a fee for brokering the swap for the two counterparties, by obtaining a small interest rate spread (or differential) between the two parties' positions, usually on the fixed-rate leg of the swap. On rare occasions, intermediary banks also charge a fee for arranging swaps.

b. Interest Rate Futures Contracts.

In an interest rate futures contract one party agrees to sell and deliver, and a second party agrees to purchase, at a specified price, place, and time in the future, a specified financial instrument. The underlying security may be one of a number of U.S. Treasury obligations, a municipal bond, a certificate of deposit, etc. Certain futures contracts substitute for the purchase and sale of a specific financial instrument a final cash payment, which is determined using a market index (such as Standard & Poors or 90-day Eurodollar rates).

(i) Purposes.

The taxpayers sell futures contracts (*i.e*., obligate themselves to deliver designated securities at a specified place and time in the future) for two purposes: either for hedging or as a commodity of trade for profit.

(ii) Futures Contracts as Hedging Vehicle.

As an example of the function of futures contracts for hedging purposes, suppose that a bank required $1,000,000 in order to fund a six-month loan. The bank may, however, be unable to find a person willing to purchase a certificate of deposit at an acceptable rate for the entire period. The bank might instead have to issue a series of two 90-day $1,000,000 certificates of deposit. This method of funding the loan would expose the bank to interest rate risk. If interest rates go up, the cost of the funds (*i.e*., the interest paid to the second certificate of deposit holder) might approach, equal, or even exceed the return on those funds (*i.e*., the interest received from the bank's loan customer), thus resulting in a lower net interest margin, no margin, or perhaps even a net loss. Of course, the bank would reap a greater net interest margin from the transactions if interest rates were to fall, but such speculation is not the bank's purpose. Their goal is to lock in a reasonable net interest margin by fixing the interest rate they will pay over the six-month period.

One way to do this is to enter into a three-month futures contract to hedge the interest rate on the second 90-day certificate of deposit (when the first certificate expires). The futures contract would provide for the bank to sell a $1,000,000 certificate of deposit at the end of the three-month period at a fixed interest rate of, for example, 13.5 percent, a rate that will provide an acceptable net interest margin to the bank in light of the interest it will receive from its loan customer.

The actual interest paid on the second 90-day certificate may be above or below this targeted 13.5 percent interest rate. However, if interest rates rise during the first three months, so does the value of the bank's futures contract because the market price of a 13.5 percent C.D. falls below the specified price at which the bank will sell. In practical terms, the futures contract is "marked" to its fair market value at the end of each business day based upon changes in interest rates during the day. A cash settlement is made each day between the parties to reflect the change in the value of the contract. Over the course of the contract, this cash settlement process offsets the interest expense of the bank on the C.D. Thus, the bank may pay interest in excess of 13.5 percent on the second 90-day certificate of deposit, but these added interest costs will be offset by the cash settlements from the futures contract buyer.

Conversely, if interest rates fall, the bank will pay less interest to the second 90-day C.D. holder, but the value of the futures contract will also fall and the cash settlements to the futures contract buyer will increase the bank's interest cost. The net effect of the entire transaction is that the interest paid to the second 90-day C.D. holder, when offset by the cash settlements paid to or received from the futures contract buyer, will approach or equal 13.5 percent.

Thus, the purpose and effect of these futures contracts is to hedge interest rate exposure, rather than to generate income from trading.

(iii) Trading Futures Contracts.

The taxpayers and numerous other Washington businesses - securities broker-dealers and others as well as banks - also engage in the purchase and sale of futures contracts 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. For example, suppose a futures contract provides that the seller will deliver a Treasury Bill three months in the future at a specified price, rate, and place. If T-Bill rates rise, and hence prices of T-Bills at the specified rate fall, the seller of the future will recognize a gain when he purchases the T-Bill at the current market price and sells it at the specified contract price, which is now above market. This relationship holds true also of the reverse situation: if current market rates fall, the price of the T-Bill will rise and the seller will be forced to deliver the T-Bill at a below-market price, thus realizing a loss.

The Department understands that the reasons why banks, broker-dealers, and other businesses take part in the futures market are more complex than the market forces just described would indicate. In fact, broker-dealers often buy and sell the same futures contract, i.e., a fungible contract having exactly the same terms, many times within a single day.

Broker-dealers and others have developed and engaged in several different strategies for speculation in securities markets. With respect to futures contracts, these strategies range from outright holding to complex "spread" strategies. A "spread" exists where there is a differential in interest rates offered by similar securities. For example, a spread might exist between a T-Bill and a T-Bill futures contract, a T-Bill and a T-Bond futures contract, or a municipal bond and a T-Bond futures contract. For most broker-dealers, the Department understands, trading in securities cannot be separated in practice from trading in futures contracts because the opportunity for profit frequently arises from the trader's ability to buy and sell in more than one market at the same time. The several markets for different instruments together constitute a unified market for financial instruments.

A corresponding result of the rapidity of trading is that a broker-dealer seeks an extremely small profit on trading with respect to the gross dollar amounts traded. The taxpayer-petitioners assert that to be competitive, a broker-dealer expects to make an overall margin of at least .03% on a long-term securities and .005% on short-term securities. Returns above .20% are virtually unknown.

2. The Tax Consequences of New Financial Instruments.

In their memorandum referred to above, the taxpayers point out alleged differences between interest rate swaps for hedging purposes and intermediated swaps. They believe that these alleged differences should dictate different tax treatment. The central difference argued by the taxpayers and described more fully below, is that a swap for hedging purposes affects the expenses (and therefore the margin) associated with a lending activity but not the revenue. The taxpayers argue that it is not a separate activity generating taxable gross income in isolation. Conversely, the taxpayers stipulate that intermediated swaps are a separate activity in which businesses engage for the express purpose of generating additional revenues.

It appears from the record of Final Determination No. 85-117B that the same arguable differences exist with respect to interest rate futures. We will treat the following discussion as applying equally to swaps and futures.

a. The Tax Consequences of Financial Hedges.

The current position of the Audit section on financial hedges, as expressed in Determination No. 85-117, is represented by the taxpayer-petitioners in the form of the following syllogism:

1. The value proceeding from any activity engaged in with the object of "gain, benefit, or advantage" is taxable gross income. RCW 82.04.080, .140.

2. Taxpayers enter into interest rate swaps and interest rate futures contracts with the object of "gain, benefit, or advantage."

3. The value proceeding from interest rate swaps and the gain on interest rate futures are taxable as gross income.

The taxpayers attack the premise of this syllogism by noting that both buying and selling are activities that people engage in for "gain, benefit, or advantage" and yet the State only taxes sellers. That is, selling cars is taxed whereas buying cars is not. Similarly, lending money is taxed whereas borrowing money is not. From this fact, the taxpayers conclude that "business activity" is in fact divided into two species - taxable income-generating activities and nontaxable expense-generating activities. A business is taxed under B&O tax on selling goods or services but is not taxed under B&O tax on purchasing goods or services.

The taxpayers then claim that financial hedges such as swaps and future contracts are not taxable because the banks' purpose is to purchase a cash flow that offsets its funding expense. The cash flow received from the counterparty is the equivalent of the goods or services one receives from a subcontractor. The bank pays another party for a cash flow in order to control costs (not to maximize gross income), just as an over-extended prime construction contractor might pay another contractor to do part of its job in order to control costs. These subcontracting efforts are the equivalent, in another analogy, of insurance against the risk that current market conditions will not stay the same. The proceeds of insurance do not constitute taxable gross income. Therefore, under the taxpayers' comparison, financial hedges do not generate gross income as understood in Chapter 82.04 RCW, but instead have a positive or negative effect on the cost of doing business.

Although the taxpayers press this argument with much force, they have offered to forego pursuing it with respect to "matched swaps" and "matched" futures contracts if the Department agrees to impose tax only on the net proceeds derived from such transactions, i.e., the "gains" actually realized.

b. The Tax Consequences of Intermediated Swaps and Futures Trading.

The current position of the Department, tentatively expressed in Determination No. 85-117, is that swaps and futures contracts are not securities and therefore do not qualify for the netting of trading losses and gains to arrive at taxable "gross income." The taxpayers attack this position with a lengthy analysis of the statutory section that defines "gross income of the business," RCW 82.04.140. Their analysis is intended to support treating these instruments as analogous to securities.

RCW 82.04.140 provides as follows:

> "Gross income of the business" means the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, 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, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

The taxpayers first note that the definition of "gross income" includes examples that apparently proceed from different economic theories. The taxpayers note, for example, that businesses selling cars are taxable on the "gross proceeds of sales" - i.e., the full sales price of vehicles sold. This is a far larger tax base than the tax base applied to lenders (interest, rather than principal repaid plus interest) or securities brokers ("gains realized from trading," rather than gross proceeds of the sale of securities). The taxpayers assert that the words "and includes" appearing before the enumeration of various types of income denotes that the enumeration is a list of examples from which legislative policy must be implied. The role of the Department, therefore, is to elaborate the policy expressed in the list and apply it consistently to business activities not specifically described in the statute.

The taxpayers then show that the common feature of interest and gains realized from trading securities is that they result from activities that involve in principle the transfer of money alone, and not goods and services. The legislative policy, implied but not articulated in the statute, is that businesses that transfer money for money cannot or should not be taxed on the entire amount received - either because to do so would erect too high a barrier to the flow of capital or it would unfairly tax amounts that do not enhance the business' wealth. In any event, the taxpayers claim, financial businesses are taxed only on the margin, or on the return on capital.

Intermediated swaps and futures trading are no different in principle from lending or securities trading, in the taxpayers' view. Both activities involve the trade of money for money, or money for the obligation to pay money. In each type of transaction, the bank or other business is buying and selling its own cash obligations. The legislative policy necessarily implies that this activity be treated the same way as buying and selling another party's cash obligations (i.e., securities).

The taxpayers have also pointed out that imposing the Service business rate of tax on the gross cash flow associated with these activities would make them prohibitively expensive. The tax would arguably wipe out much more than the gains from futures trading and intermediated swaps. Arguably, intermediated swaps and futures trading would cease to exist in Washington, while the types of lending and securities-trading strategies pursued in Washington would be significantly narrowed because of the inability to hedge. Much the same results would occur, for example, if the tax were applied to all receipts from sales by securities dealers or all loan proceeds received by banks.

c. Timing of Tax Reporting.

The taxpayers have indicated their belief that it is appropriate to report gains from intermediated swaps and futures trading on the same monthly schedule that is established for securities trading under W.A.C. 458-20-162. This is so for swaps because intermediary banks customarily engage in a substantial volume of intermediated swaps and maintain a predictable margin on the swaps under contract. Futures trading, similarly, is conducted in substantial volumes and normally at a rapid pace. In both cases, moreover, generally accepted accounting principles and federal tax law require current recognition of net income.

With respect to swaps for hedging purposes, however, the taxpayers contend that two rules are required. First, with respect to "matched swaps" that are tied to an underlying liability, the taxpayers have offered to pay tax on the "gains realized" if the Department agrees that RCW 82.04.080 permits taxation only at the termination of the agreement. This rule would follow from the fact that the bank enters into a hedge to offset the long-term funding costs associated with some identified banking activity. Since the effect of the swap is not known until its termination, the "gains realized" cannot be known until the transaction is completed.

However, where a taxpayer engages in a continuous, flexible interest rate hedge program to meet an aggregate hedging requirement, which is not matched to specific funding liabilities, the taxpayers contend that the swap transactions cannot in an economic sense be considered "complete." As such, the hedge program is an ongoing regulation or control of the business' interest expense and cannot reasonably be taxed.

With respect to futures contracts matched as hedges to specific funding liabilities, on which the taxpayers have offered to pay tax on "gains" putatively realized, the taxpayers suggest using the same reporting schedule that is applicable to futures trading. Because cash settlements are realized on a daily basis, reporting "gains" on a monthly basis would not be at odds with the economic impact of the

futures contract. However, if futures contracts are used in aggregate hedging programs, the taxpayers believe that taxation at any particular point would be improper.
Arguendo, and at the department's request, the taxpayer-petitioners submitted a post-hearing proposal for the timing of tax reporting if ongoing hedging programs, including interest rate swaps and/or futures contracts, are ruled to be taxable business activities.

DISCUSSION

For purposes of clarity and ease of understanding we will first discuss the taxability of matched interest rate swaps, interest rate futures contracts, and intermediated swaps as independent transactions and as used for hedging purposes. We will then deal with interest rate swaps and futures as part of ongoing rate hedging programs.

I. Does Washington Law Require That the Measure of Business and Occupation Tax Imposed Upon For-Profit Interest Rate Swaps and Interest Rate Futures Contracts Equal "Gains Realized"?

RCW 82.04.080 provides:

> "Gross income of the business" means the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, 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, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

[1] The question presented is how this statute applies to receipts from intermediated swaps and trading in futures contracts. The taxpayers have urged the Department to

consider this statute in its totality to ascertain the legislature's intent with respect to the taxation of swaps and futures. We agree that this is the proper approach to determining the measure of tax imposed upon a service business not specifically described in the statute.

RCW 82.04.080 in pertinent part states that the measure of tax equals "the value proceeding or accruing by reason of the transaction of the business engaged in." "Value proceeding or accruing" has been defined by statute as

> the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued.
>
> RCW 82.04.090.

This definition has at times been given an expansive reading by the courts. In Engine Rebuilders, Inc. v. State, 66 Wn.2d 147, 401 P.2d 628 (1965), for example, the court stated that the idea implicit in this definition is "that the tax applies to everything that is earned, received, paid over to or acquired by the seller from the purchaser . . . ." Id. at 150.

The taxpayers point out that this broad reading is not strictly adhered to in practice. For example, lenders are not taxed on repayments of principal indebtedness, even though repayment is obviously "consideration" for the loan. Similarly, securities dealers are not taxed on that portion of a stock's selling price that equals the dealer's own purchase price for the stock, though the entire selling price is obviously "consideration."

The taxpayers' point raises the question whether this treatment of lenders and securities dealers is correct under the law. To answer that question and to determine the measure of tax for swaps and futures contracts, we revert to the definition of "gross income." In pertinent part, RCW 82.04.080 states that "gross income of the business"

> includes gross proceeds of sales, 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 . . . .

The term "includes" is a vague introduction to this list of types of income. Ordinarily, use of the word "includes" does not imply exclusion of the things not mentioned. Thus, the statute includes interest in "gross income" but does not seem to exclude principal payments. The statute includes gains realized from securities trading, but does not seem to exclude recovery of the purchase price. Yet since the enactment of the statute in 1935, B&O tax has not been assessed against the recovery of principal indebtedness or of the purchase price of securities. The legislature has never objected to the administration of the statute in this way. We take the silent acquiescence of the legislature as confirmation that the current administrative position on these points is correct.

There is a clear way of squaring the statutory language of RCW 82.04.080 with the legislature's intent not to tax the recovery of principal indebtedness or of the purchase price of securities. In using the term "includes" the legislature was, through this vague introduction, specifying policies for the measure of tax to be imposed on certain activities. In this reading, the policies expressed in the enumeration of types of income were intended to control even if there is a perceived conflict with the broad definition of "value proceeding or accruing." By including interest and trading gains in the list, the legislature implied a policy of taxing financial businesses on their gross margin alone.

This understanding of the statutory definition is consistent with the general theory that has long prevailed in interpretation of the B&O tax statutes, which is that the legislature intended to tax all income-producing business activities unless otherwise exempted. It strains the tradition to believe that the legislature specifically intended to use the enumeration of income types in RCW 82.04.080 as a test for taxability. The language of RCW 82.04.080, where "gross income" is said to "mean" one thing ("value proceeding or accruing") and to "include" subsets of that thing, is more naturally read to imply limits on "value proceeding or accruing" than to make them express.

We therefore agree with the taxpayers that the enumeration of income types is a real, if implied, expression of legislative policy concerning the measures of tax to be imposed on different financial business activities. We also agree that the legislature's policy with respect to lenders and securities traders is to impose tax only on the gross margin and not on the gross "consideration." Finally, we agree that, given the implicit manner in which the legislature has expressed this policy, there is no justification for limiting application of the policy within the financial business marketplace to lenders and securities traders.

It is not reasonable to assume that the legislature identified lenders and securities traders in order to specify the limits on its policy. Instead, it is more probable that they were identified as the two wings of the financial business then in existence, which the legislature intended to tax in a special way because of its peculiar economic position. The taxpayers uncontroverted testimony is that financial businesses would experience a severe impact if the total cash flow involved with swaps and futures were subject to tax, and we think it is plausible that the legislature had this impact in mind when enacting RCW 82.04.080.

Therefore, we find that the general treatment of trading in securities (i.e., trading in evidence of indebtedness) under RCW 82.04.080 should apply to intermediated interest rate swaps and trading in futures contracts (i.e., trading of indebtedness). The two interest rate instruments both represent the value of future payments of cash. Their markets both involve cash payments for cash obligations. These activities are therefore like securities trading in the respects that would lead the legislature to impose tax on it measured by the gross margin only. Because we view the legislature's intent as establishing "gains realized" as the measure of tax not only for securities trading but also for activities like securities trading, we find that RCW 82.04.080 imposes tax on the gains realized from intermediated interest rate swaps and interest rate futures trading. This conclusion represents the department's interpretation of the intended application of current statutory law. It is the department's administrative policy position, absent legislative clarification.

II. How Shall the Taxpayers Report Gains Realized From Interest Rate Swaps?

Because we have determined that the gains realized from intermediated interest rate swaps and "matched swaps" for hedging purposes are to be taxed, it is necessary to elaborate the timing and method of reporting. The answer is found in part in the definition of "gross income of the business" in RCW 82.04.080.

"Gross income" is taxable when it is earned "by reason of the transaction of the business engaged in." Id. Because "gains realized" is the applicable measure of "gross income," we are concerned with the timing for taxation of "gains realized" "by reason of the transaction of the business engaged in." The Department has long interpreted these words to mean that trading gains are known only when the "business" has been transacted, i.e., when the transaction comprising the "business activity" is complete. The period in which the transaction is completed has therefore traditionally been the period in which the gains are reported and taxed.

This principle applies readily to securities trading, because discrete purchases and sales make up the transactions that comprise the business. See W.A.C. 458-20-162 (Gross Income From Trading). The results from completed transactions can therefore be easily totalled on a periodic basis (monthly) for reporting purposes.

This method of reporting gains from securities trading applies less readily to interest rate swaps because a swap agreement customarily calls for the periodic exchange of payments over the term of the agreement rather than a single payment made upon conclusion of the sale. This characteristic of payments under swap agreements makes them similar to true interest, which is also received on a periodic basis and is reportable monthly as it is received. But analogizing swap payments to interest does not provide an accurate methodology for reporting such payments either, because the receipt of interest is not based on an exchange of instruments. These two methodologies nevertheless illustrate the proper reporting methods for swaps, because they show that the method of tax reporting follows from the contribution of the activity to the business.

Intermediated swaps, like true interest on loans, generate a stable and continuous flow of cash for the intermediary. We agree with the taxpayers that intermediated swaps generate gains on an ongoing basis regardless of the changes in actual interest rates paid over the course of the agreement. Intermediaries should therefore report gross income, calculated pursuant to W.A.C. 458-20-162, in the earnings account entitled "All Other Sources," by netting the offsetting payments.

"Matched swaps" for hedging purposes, on the other hand, are entered into with the end point in view: to achieve a fixed interest cost for the particular banking activity. This type of swap is not intended to provide a steady income, but to balance out over time as the variable rate floats up and down. The real gain or loss is not made on a periodic basis, but as a result of the fluctuations over the extended period of the swap's existence. We consider a "matched swap" for hedging purposes to be more like a securities exchange than a stream of true interest for tax purposes. To require current monthly reporting of the gain from a hedging swap would be akin to requiring current monthly reporting of changes in the value of a securities portfolio. Therefore, hedging parties to a "matched" interest rate swap should deduct payments made from payments received at the close of the swap and include the resulting figure in the gross income earnings account entitled "Trading" in the month when the swap is closed.

[2] III. How Shall the Taxpayers Report Gains Realized From Interest Rate Futures Contracts?

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 W.A.C. 458-20-162, as gross income in the earnings account entitled "Trading."

Though the taxpayer-petitioners have conceded liability for gains realized from matched swaps and intermediated swaps, for hedging or other purposes, it is our finding that such liability arises under operation of law, whether conceded or not. Thus, while we are prepared to administratively accept that concession, it is not the basis of our ruling here.

IV. Are Hedge Transactions (Ongoing Interest Rate Swaps and Interest Rate Futures Contracts) Taxable Activities?

The taxpayers contend that hedge transactions are not subject to B&O tax because they only affect the cost of doing business and do not generate gross income. The taxpayers have offered to pay tax, however, on the overall "gain" from hedge transactions that are "matched" to specific underlying obligations that are being hedged. While we are prepared as an administrative matter to accept this concession, we are also convinced that these transactions are taxable as a matter of law.

RCW 82.04.140 provides:

> "Business" includes all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person of class, directly or indirectly.

RCW 82.04.150 provides in part that the term "engaging in business" "means commencing, conducting, or continuing business."
We reaffirm the decision in Determination No. 85-117 that interest rate swaps and interest rate futures contracts of any kind constitute "business" under RCW 82.04.140. There can be no question that the taxpayers are engaging in these transactions "with the object of gain, benefit, or advantage." It follows that when the taxpayers engage in these transactions, they are "engaging in business" under RCW 83.04.150.

RCW 82.04.220 provides:

> There is levied and shall be collected from every person a tax for the act or privilege of engaging in business activities. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.

The first sentence of this section establishes that the taxpayers are subject to tax by virtue of engaging in interest rate swaps and futures contracts for hedging purposes. The tax is applied against the "gross income of the business" (the other tax bases being inapplicable).

The question is therefore whether hedge transactions yield "gross income of the business," as defined in RCW 82.04.080. That term is defined to mean

> the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, 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, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

RCW 82.04.080. The "value proceeding or accruing" from the transaction of the business, which is the fundamental measure of "gross income" as defined, is further defined in the statute as

> the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued.

RCW 82.04.090. The question appears to be whether amounts received pursuant to a swap or futures contract constitute "consideration" received or accrued by reason of the transaction of the business engaged in.

[3] We agree with the taxpayers that the definitions of "consideration" and "business" in the B&O tax statutes are broader in literal scope than their intended application. "Consideration," for example, does not include all money received or accrued by a business entity. The Department has never applied the term "consideration" for this purpose to deposits received by a bank, although a bank is obviously in the "business" of taking deposits and paying interest thereon. The same is true for a construction company, for example, that receives loan proceeds from a bank, although borrowing is an activity engaged in with the "object of gain, benefit, or advantage." The same is also true of a corporation's receipt of proceeds from the issuance of stock or bonds. Each of these types of receipts is "consideration," in the ordinary meaning of the term, for the things or promises given up. Yet the Department has not treated them as taxable "consideration" received or accrued "by reason of the transaction of the business engaged in." We take the legislature's long, silent acquiescence in this treatment to be confirmation that the Department's position on this point is correct.

The common denominator of these three cases is that the taxpayer is obtaining money for use in its business. In each case, the taxpayer is committing itself to some present or future expense to obtain an economic "input" for its business. We agree with the taxpayers presenting this petition that this is the characteristic that distinguishes taxable from nontaxable receipts. The taxpayers' contention is that this distinction between taxable and nontaxable "consideration" mirrors a parallel categorization of "business" activities. The latter are in fact divided into taxable "income-generating" activities and nontaxable "expense-generating" activities.

We agree. This distinction has implied support in the definition of "gross income of the business" in RCW 82.04.080, where the enumeration of types of income such as gross proceeds of sales, compensation for the rendition of services, royalties, and commissions implies that "gross income" means the receipts from "selling" activities. No item in the enumeration constitutes the proceeds of a "purchasing" activity.

We disagree with the taxpayer-petitioners, however, that ongoing hedging programs generate no taxable income. We also disagree with the proposition that taxing such activities results in taxing "purchases" or the mere reduction of costs. These are simply theoretical arguments, unsupported by case law or other reliable legal authority. In fact, according to the taxpayer-petitioners' own testimony and the materials submitted for our review, it is clear that the ultimate purpose of ongoing hedging programs is to derive economic gain and benefit. These programs are business activities engaged in by banks and financial institutions for their own financial well being. They stand alone, separate and apart from banking or financial services rendered for clients. As earlier explained, this activity constitutes "business" resulting in financial "value proceeding or accruing" over the long term. It stands without question that the financial institutions both purchase and sell, by swapping, the interest obligations on underlying investments for the singular purpose of improving their fiscal posture in the marketplace. It is not a valid argument against taxability of this activity that these institutions must do so in order to remain competitive or to be able to continue offering long-term fixed rate loans to the public. If, as a matter of public policy, the business activity of conducting interest rate hedging programs is to be a tax exempt activity, that is a matter for legislative decision.

We perceive no valid distinction between the business purposes of
matched swaps used for hedging reasons and unmatched swaps folded into a more sophisticated hedging program. The business objective is the same whether the investments underlying these financial dealings are traceable or not. It is not acceptable, nor is it supportable under law, to argue that financial business dealings no longer derive taxable gross income of the business simply because they are of a complex, sophisticated nature. The difficulty confronting the taxpayers and the department in determining the incidence (completion of the taxable activity) and the measure (amounts derived from doing the business) does not justify a conclusion that it is not reasonable or possible to tax these activities.

Based upon all of the information available to us, we perceive the unmatched, ongoing hedge programs to be distinct financial business activities undertaken with the object of gain, benefit, and advantage to the taxpayer-petitioners. For all of the same reasons stated earlier with respect to matched swaps, we must conclude that unmatched interest rate swaps involved in ongoing hedging programs derive taxable gains to financial institutions who engage in such activities. Also for reasons earlier explained, we conclude that the "gains" realized are the appropriate tax measure under the law. The more difficult issue is to determine when such gains are realized and identifiable for tax reporting purposes. Because the legislature of this state has not had occasion to address this knotty question, we are left to our own administrative applications.

RCW 82.32.300 generally vests the department of revenue with the authority to determine the procedure for the making of tax returns and the ascertainment and collection of taxes due and to exercise general supervision for the collection of taxes. WAC 458-20-100(18) provides for the method of obtaining such a departmental ruling of taxability which the taxpayer-petitioners have sought in this case.

Regarding the taxpayer-petitioners characterization of the current position of the department's Audit section as a simple syllogism (See p. 12, supra), we do not concur with this approach. It is overly simplistic and does not, in our view, properly reflect the entirety of the business activity engaged in by financial institutions which employ unmatched interest rate swaps for ongoing hedging purposes. In fact, to view only the "interest earned" aspect of such programs in computing the "value proceeding" from interest rate swaps, and ignore the inherent expenses incurred in making such swaps would predicate tax liabilities upon only a bifurcated part of the entire business activity. Conversely, however, to consider this swapping and hedging activity as merely a cost reduction function, as the taxpayer-petitioners urge us to do, would result in ignoring the ultimate financial benefit derived from the activity. We reject both of these positions as a matter of tax administrative policy. Rather, the statutory definitions and provisions referenced earlier, which control this question, contemplate that the entire business activity of swapping interest rates and futures for hedging purposes should be considered. That is, the "gross income of the business" from this activity cannot be determined by examining only one side of the equation nor can it be determined until the activity is completed to the extent that tax reporting is required.

Moreover, there is precedent under the rules relating to the Revenue Act of this state for evaluating the entirety of certain kinds of business activity before determining their tax consequences. WAC 458-20-162, as explained earlier, properly expresses statutory intent that only the "gains" on certain financial trading are subject to business tax. In a homelier sense, WAC 458-20-131 treats as taxable "gross receipts" from games of chance or merchandising games only the "increases" realized from such activities after payouts are made. In short, the taxable activity is not deemed to be complete until after the incoming revenue flow and the outgoing revenue flow have been taken into account. The payouts are not deemed to be costs of doing business and therefor nondeductible for tax purposes. They are recognized to be an inherent part of the entire business activity being conducted and to be a necessary factor in determining taxable "gross receipts". To continue the analogy, the difference between hedging programs using interest rate swaps and games of chance is that in the case of the former it is difficult to tell when the game is over. Nonetheless, it is the responsibility of the department of revenue to provide the procedures for reporting the taxability of such activities.

At the department's request, in a letter dated November 6, 1989, the taxpayer-petitioners submitted a proposal for the proper timing for reporting income from interest and futures swaps used in continuous hedging programs, albeit that they continued to press the argument that such programs should incur no tax liability. The letter states:

> Continuous (Portfolio) Hedge Programs. The Taxpayers do not believe that the receipts involved in a continuous hedge program are taxable at all. However, you asked us to comment on reporting methods for continuous hedge programs for your consideration in the event that you determine that the margin on such programs is taxable.
>
> As we have described it, a continuous hedge program such as the one conducted by . . . Bank is used to

> hedge the entire portfolio of a bank's interest rate risk. The swaps and futures are matched to broad categories of bank assets or liabilities, but they have no identifiable impact on the profit or loss on specific banking transactions. The periodicity of receipts ranges from the daily cash settlements on futures to the monthly, quarterly, or annual payments on swaps. Moreover, the bank is hedging its exposure to interest rate fluctuations that can have a very long cycle - up to several years, as you know.
>
> As with intermediated swaps, these factors cause the "gains" and "losses" from such a program - i.e., the net cash flows and mark-to-market adjustments on these transactions - to vary considerably over the short term. To measure and close out this impact at any one date would not reflect the actual economic impact, because receipts at any one time necessarily relate to the interest rate exposure the bank faces in the future. (We note that under generally accepted accounting principles these "gains" and "losses" are generally deferred and amortized over the life of the hedged items.)
>
> Therefore, the appropriate method of reporting would be an open-ended computation of the "gains" from the activity that reflects "losses" incurred in prior periods. That is, any reporting period - month, quarter or year - would be appropriate, but only if losses on the program may be rolled over or carried forward indefinitely. Because the entire purpose of the program is to stabilize interest expense over the long term, all short-term "losses" should be eventually offset by "gains."

We are not persuaded to approve a tax reporting method which authorizes an open-ended computation with rolling "loss" carryovers. Such reporting methodology, we feel, would create insurmountable administrative problems considering the statutory time limitations for tax assessments and tax refunds under RCW 82.32.050 and 82.32.060. Under such a method a taxpayer's books could never be closed or its accounting of income concluded with any degree of assurance or finality.

Moreover, in our view such unique tax reporting methods are beyond the scope of general accounting principles such that they would be appropriate only for legislative dialogue. However, the taxpayer-petitioners' proposal provides sufficient insights from which a resolution of the timing issue is possible. We are satisfied that tax reporting of gross receipts from continuous hedge programs can be accomplished annually by using an annualized monthly average of gains and losses. In this manner the taxpayer-petitioners' stated purpose, "to stabilize interest expense over the long term" and the claim that "losses are eventually offset by gains" are administratively recognized. This appears to be the most equitable and practical solution, providing the greatest degree of uniformity and reliability from an administrative perspective. In our view it is a "just and lawful" resolution as contemplated by RCW 82.32.160 which is the genesis of WAC 458-20-100 under which this ruling is sought.

The reasoning supporting these decisions and the disposition of the respective issues discussed herein are limited in application to the specific kinds of hedging transactions considered here. They are not to be construed as standing for the general proposition that expenses or costs of doing financial business may be deducted from gross receipts for taxation purposes.

DECISION AND DISPOSITION

The taxpayer-petitioners are directed to report gross income and pay tax in accordance with the foregoing Discussion. Completed or ongoing audits not in accord with the findings and conclusions hereof will be referred to the Audit section for reevaluation.

To the extent that Determinations No. 85-117 and 85-117B are not in accord with this Determination, they are hereby clarified and corrected.

The reasoning supporting these decisions and the disposition of the respective issues discussed herein are limited in application to the specific kinds of hedging transactions considered here. They are not to be construed as standing for the general proposition that expenses or costs of doing

financial business may be deducted from gross receipts for taxation purposes.

DATED this 13th day of February 1990.