Cite as 9 WTD 276-1

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

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 90-113
. . .	)	Registration No. . . .
	)	Tax Assessment Nos. . . .

[1] **RULE 146:** B&O TAX - INTEREST - PARTICIPATION. When loan agreements do not prohibit assignment or sale by the lender, the lender is authorized to assign or sell the loan, and interest collected by the seller of a loan participation for the owner of the participation is exempt. Portland Electric & Plumbing and Levinson v. Linderman cited.

[2] **RULE 162:** B&O TAX - SECURITIES - CALCULATION OF INTEREST - AMORTIZATION OF PREMIUM OR DISCOUNT. Amortization of the premium or discount recognized by a taxpayer at the time of a security's original purchase is properly reportable (and deductible, if U.S. government interest) as an addition or reduction in income on a monthly basis under the accrual method of reporting.

[3] **RULE 162:** B&O TAX - SECURITIES - SALE - GAIN OR LOSS. A security's book value (basis) should be adjusted to reflect the amortization of a premium or discount before calculating gain or loss at the time of the security's sale.

[4] **RULE 155:** USE TAX - COMPUTER SOFTWARE - LICENSE TO USE. Payments for a license to use computer software were subject to B&O tax under the service classification prior to the amendment of Rule 155,

effective August 7, 1985. After that date, such licenses are deemed to be retail sales subject to Retailing B&O tax and retail sales or use tax. . . . .

[5] RULE 162: B&O TAX - "GROSS INCOME OF THE BUSINESS" - "ACCOUNT" AND "EARNINGS ACCOUNT" - CONSTRUED. The words "account" and "earnings account" refer to the various types of gross income discussed in the remaining paragraphs of the rule: gross income from interest, gross income from commissions, gross income from trading, and gross income from all other sources.

[6] RULE 162: B&O TAX - TRADING - GAINS AND LOSSES - ARBITRAGE - HEDGING. Because arbitrage transactions are analogous to those of matched hedging and futures transactions, the various components of an arbitrage transaction - both gains and losses - will be recorded in the trading account in the month when the last component of the transaction is completed.

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: November 21, 1985

NATURE OF ACTION:

Petition concerning taxes on computer software leases, items claimed to have been shipped out-of-state or abandoned, participation interest on installment credit loans, amounts received for credit reports and filing fees, underreported gains on sales of securities, trading losses, premium amortizations, and accrued interest on . . . mortgage-backed securities.

FACTS:

Bauer, A.L.J.-- The taxpayer's records were audited for the periods . . . through . . .; . . . through . . .; . . . through . . .; and . . . through . . . . As a result, the above-referenced tax assessments were issued.

The taxpayer is a bank.

ISSUES AND TAXPAYER'S ARGUMENTS

Issue #1 (. . .). Whether use tax was properly assessed on the sale of assets out-of-state.

The taxpayer argues that sales tax was erroneously assessed on the sale of property shipped to out-of-state destinations.

Issue #2 (. . .). Whether interest from . . . mortgage-backed securities was deductible.

The taxpayer argued that its deduction of interest from federal mortgage-backed securities carried by it as an investment should not have been disallowed, since they were ultimately primarily secured by residential mortgages.

Issue #3 (. . .). Whether interest collected and paid to the owner of a participation in Visa installment credit loans is taxable.

The Comptroller of the Currency requires a certain ratio of total capital to total assets. To comply with this requirement, the taxpayer occasionally must reduce the size of certain of its assets. One widely-accepted method of doing so is to sell participations in its loans to other financial institutions.

When a participation is sold, the seller retains administrative control over the loan. This allows the seller to maintain its relationship with its client. The seller thus collects the interest and loan amounts, and passes on the appropriate percentage to the owner of the participation. In addition, there is often a "service fee" differential retained by the seller.

The taxpayer sold participations in its . . . loan portfolio, and continued to service the loan during the audit period. The auditor taxed all of the interest received on the loans, including the amount to be passed on to the owner of the participation. The taxpayer paid service tax on its "service fee differential."

The taxpayer objects to the taxation of the interest required to be passed on to the owner of the participations. It cites ETB 463.04.146 as authority for its position.

Issue #4 (. . .). Whether interest income from premium amortization on the sale of obligations is taxable.

The taxpayer argues that this also involves a conflict between the cash and accrual methods of accounting and reporting taxes. The auditor allegedly disallowed the amortization of premiums. The taxpayer contends that amortization accurately reflects its income, and that such an accrual method is standard industry practice.

The taxpayer argues that the premium paid on a security is not a deduction from "gross income," but is rather an integral part of the computation of "gross income."

There are a number of short-term securities which are actively traded in financial markets. Yields on such instruments vary daily, and the purchase price is determined by the combination of the interest rate of the security and the market yield to maturity.
Most of such securities were purchased by the taxpayer from brokers and were part of the taxpayer's strategies in managing its liquidity. Depending on market conditions, the securities would be purchased at a premium or a discount from the face value of the security. In order to calculate the actual interest earned (accrued basis as required by the Comptroller of Currency), the stated rate of the security is adjusted by the accretion of the discount or premium on a monthly basis to maturity. Income from such securities was reported to the Department in accordance with Rule 146.

Issue #5 (. . .). Whether business and occupation tax was properly due on gain from the sale of securities, when accretion income had already been reported on a monthly basis.

The taxpayer's income is recorded on an accrual basis as required by the Comptroller of the Currency. Material income is reported in the period earned rather than when actually received. When securities are purchased below par, the resulting discount is accreted on a monthly basis to the maturity of the security involved (accrual basis). In . . . accretion income amounted to $ . . . for the month and $ . . . for the year.

In accordance with WAC 458-20-146, accretion income was included in the taxable income reported to the State.

On the other hand, the taxpayer reports its dealings in securities on a cash basis for federal tax purposes. Therefore, accrued accretion income is excluded from taxable net income and is taxed at the time of a security's sale or maturity. As a result, there is a difference between book gain and tax gain on securities sold,

B&O tax has been paid on this difference on a monthly basis as recorded. For federal income tax purposes, tax liability is deferred until securities mature or are sold.

The taxpayer argues that to again assess B&O tax on the federal income tax profit (cash basis of accounting) - after the taxpayer has already paid tax on the monthly accretions (accrual basis accounting) - results in double taxation. It submits that it should be permitted to either exclude accretion income from monthly B&O returns and defer payment of the tax until maturity/sale, or the income should be accepted as filed.

Issue #6 (. . .). Whether sales tax is due on the lease of computer software.

The taxpayer petitions for a refund for use taxes paid as the result of assessments in prior audits.

The taxpayer uses computer software by way of a licensing agreement. The software systems it uses are modified to adapt to the taxpayer's particular needs, and are constantly maintained with new releases. Part of the taxpayer's contracts requires the licensor to maintain changes, which are constant, and to be available for questions. The taxpayer made available sample portions of the licensing agreements at the hearing, and has agreed to make available the remainder of the agreements, which were not available during the course of the audit.

Issue #7 (. . .). Whether a bank is liable for business and occupation tax on amounts received from customers for filing fees and credit reports.

Included in the amount financed for a taxpayer's borrowing customer are "amount(s) paid to others on [the customer's] behalf." Itemized as required by Comptroller of the Currency's Regulation Z, these amounts are to be paid to

public officials (for filing fees), title insurance companies, other insurance companies, credit bureaus and appraisers.

The taxpayer argues that these amounts are not "charges to customers for processing loans which represent services rendered," and contends that amounts so received are exempt from B&O tax under WAC 458-20-111 (Rule 111), "Advances and Reimbursements."

The taxpayer states that it, as a bank, does not perform any of the services paid for, and that when a customer signs a loan application, he or she knows and agrees to payment of these costs. The bank serves only as a conduit, and it is a misperception to treat money received to cover these costs as income.

The taxpayer argues that the auditor, when looking at the taxpayer's books, probably could not tell what the expense was that he was looking at. In the taxpayer's accounting system, there is only an internal document number and no other explanation. There is a high volume of such transactions - four or five entries for each loan.

Issue #8 (. . .). Whether the Department can disallow losses from securities accounts, when such accounts were established merely for the taxpayer's operational control and such accounts could have been consolidated in order to permit the netting of these losses against trading gains for B&O tax purposes.

The taxpayer is allowed to trade in securities for its own account within Comptroller of the Currency guidelines. The Department looked to the taxpayer's individual trading accounts (seven of them), and thus disallowed many of the trading losses which could have been taken had the taxpayer consolidated all of its trading activity into one account.

The taxpayer broke its trading activities into several general ledger accounts, at a more detailed level. The taxpayer then reported to various other entities the summation of these accounts.
At the time of the audit, the taxpayer was authorized to trade $ . . . a day. There was an active market. The taxpayer broke its activity down into little accounts for operational control.

The taxpayer could have recorded its trading activity in only one account, and still satisfy all of the agencies to which it

reports. It established the smaller accounts for control purposes only. For reporting purposes, then, the whole of its trading activity could have been recorded as one account - such as "trading profit/loss" -and all or most of the trading losses could then have been taken as deductions.

The taxpayer argues that the intent of WAC 458-20-162 is to tax the gains from the activity of trading. WAC 458-20-160 refers to income or loss by account, but does not state that this account is necessarily the general ledger account.

The taxpayer argues that the Department is penalizing the bank for keeping detailed records, and that none of the regulatory or accounting authorities require the reporting of anything other than trading profit or loss. The taxpayer used the smaller accounts for operational control only.

Issue #9 (. . .). Whether only the net result of an arbitrage transaction (consisting of several transactions) should be taxed, allowing losses, or whether each component of the transaction should be taxed separately.

The taxpayer states that arbitrage trading made up the majority of its trading dollars during the audit period. The Comptroller of the Currency allows these transactions because they are less risky.

Arbitrage generally involves the simultaneous or coordinated purchase and sale of two securities in which there is a relative market imbalance. The objective of arbitrage activity is to obtain earnings by taking advantage of changing yield spreads.

Thus, arbitrage is a single transaction, made up of two or more components - one a profit and one a loss. The auditor did not treat these arbitrage transactions as a single transactions with multiple components, but instead looked to all of the gain components and assessed tax, and disallowed the loss ("expense") components.

DISCUSSION:

Issue #1. Use tax on out-of-state sales. This issue was resubmitted to the audit section and has been resolved to the taxpayer's satisfaction by the issuance of a post-audit adjustment. It will not be further addressed in this determination.

Issue #2. Deductibility of federal mortgage-backed securities. This issue also has been resolved at the audit level by issuance of a post-audit adjustment. The Department has held that interest earned by the owner of federal mortgage-backed securities is deductible.

Issue #3. Interest collected on behalf of the owner of a loan participation. The taxability of interest from participation loans is governed by ETB 463.04.146, which provides as follows:

> Is interest collected by one financial institution for another to which it sold an undivided interest in a loan taxable to the former institution?
>
> Restated, the question is: In a participating loan situation must the collecting institution pay business and occupation tax on that portion of the interest collected for the participating institution? For purposes of this excise tax bulletin, a participation loan is a loan or portion thereof sold by one financial institution to another.
>
> The Department holds that in the situation described above, if the contract between the borrower and the lending institution authorizes the institution to sell or assign the loan, the institution acts merely as a conduit in collecting the assigned interest. Thus, the assigned interest is not income to the lending institution and is, therefore, taxable only to the assignee.

The auditor disallowed the deduction because the contract between the borrower and the taxpayer did not specifically provide for the sale or assignment of the loan. Under Washington law, however, contract rights are assignable unless the contract itself prohibits assignment. Portland Electric & Plumbing v. City of Vancouver, 29 Wn. App. 292, 295, 627 P.2d 1350 (1981). Further, any prohibition upon the assignment of the benefits of a contract require "very specific" and "unmistakable terms." Levinson v. Linderman, 51 Wn.2d 855, 322 P.2d 863 (1958).

The taxpayer has submitted that the agreements at issue do not prohibit their assignment or sale, and that therefore they did authorize it to assign or sell the loan. We agree.

[1] Therefore, when loan agreements do not prohibit assignment or sale by the lender, the lender is authorized to assign or sell the loan. Interest thereafter collected by the seller of the loan participation for the participation's owner is exempt.

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

Issue #4. Amortization of premium or discount and the calculation of interest income.

[2] Amortization of the premium or discount recognized by a taxpayer at the time of a security's original purchase is properly reportable (and deductible, if U.S. government interest) as an addition or reduction in income on a monthly basis under the accrual method of reporting.

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

Issue #5. Calculation of gain from the sale of securities after amortization of premium or discount.

[3] A security's book value (basis) should be adjusted to reflect the amortization of a premium or discount before calculating gain or loss at the time of the security's sale.

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

Issue #6. Sales tax on the licensing of computer software.
[4] Payments for a license to use computer software were subject to B&O tax under the service classification prior to the amendment of Rule 155, effective August 7, 1985. After that date, such licenses are deemed to be retail sales subject to Retailing B&O tax and retail sales or use tax. See Det. No. 87-359, 4 WTD 327 (1987), ...

We are satisfied from the documents supplied at the hearing that the taxpayer had entered into licensing agreements for the use of its computer software. Thus, the taxpayer's petition as to this issue is granted.

Issue #7. Charges to Customers for Credit Reports and Filing Fees.
The applicable portion of WAC 458-20-111, "Advances and Reimbursements," reads as follows:

> The word "advance" as used herein, means money or credits received by a taxpayer from a customer or

> client with which the taxpayer is to pay costs or fees for the customer or client.
>
> The word "reimbursement" as used herein, means money or credits received from a customer or client to repay the taxpayer for money or credits expended by the taxpayer in payment of costs or fees for the client.
>
> The words "advance" and "reimbursement" apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefor, either primarily or secondarily, other than as agent for the customer or client.
>
> There may be excluded from the measure of tax amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession.
>
> The foregoing is limited to cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either upon an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. It does not apply to cases where the customer, guest or client makes advances to the taxpayer upon services to be rendered by the taxpayer or upon goods to be purchased by the taxpayer in carrying on the business in which the taxpayer engages.

[Emphasis added.]

Thus, for there to be an "advance" or "reimbursement" excludable from the measure of the tax, the payments received by the taxpayer must (1) be made as part of the regular and usual custom of the taxpayer's business or profession, (2) must be services to the customer which the taxpayer does not or cannot render, and (3) the taxpayer must not be personally liable for paying the customer's fees or costs, either primarily or secondarily, except as agent for its customer.

The auditor taxed amounts received for credit reports and filing fees presumably because the third prong above was not met. In other words, it is assumed that the taxpayer had either primary or secondary liability for paying the third parties involved. Even though customers may have been made aware that they were liable for the costs involved, it is not clear that they alone were liable to the third party service provider instead of the taxpayer, or that the taxpayer had no liability.

The taxpayer has not carried its burden as to this issue. Its petition is, therefore, denied.

Issue #8. Disallowance of losses in separate investment accounts when investment accounts could have been consolidated.

WAC 458-20-162 provides in pertinent part as follows:

> With respect to stockbrokers and security houses,[1] "gross income of the business" means the total of gross income from interest, gross income from commissions, gross income from trading and gross income from all other sources: PROVIDED, That:
>
> (1) Gross income from each account is to be computed separately and on a monthly basis;
>
> (2) Loss sustained upon any earnings account may not be deducted from or offset against gross income upon any other account, nor may a loss sustained upon any earnings account during any month be deducted from the gross income upon any account for any other month;

[5] The words "account" and "earnings account" refer to the various types of gross income discussed in the remaining paragraphs of Rule 146: gross income from interest, gross income from commissions, gross income from trading, and gross income from all other sources.

The taxpayer in this case broke its trading accounts down into sub-accounts by type of security. The auditor considered each of these sub-accounts separately, and did not allow the

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[1] The Department has held this rule to also apply to banks engaging in financial businesses.

monthly losses of one sub-account to offset the monthly gains of another sub-account, even though both were trading accounts.

The gains and losses in all trading accounts should have been consolidated on a monthly basis to determine the taxpayer's "gross income of the business" as to its "trading account."

The taxpayer's petition on this matter is granted.

Issue #9. Arbitrage. The concept of arbitrage, and the arguments presented relating to the taxability of these transactions, are analogous to those of matched hedging and futures transactions.
[6] In accordance with recently published Final Determination 90-63,__WTD__(1990), the various components of an arbitrage transaction - both gains and losses - will be recorded in the trading account in the month when the last component of the transaction is completed.

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

DECISION AND DISPOSITION:

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

DATED this 19th day of March 1990.