

Cite as Det. No. 01-185, 21 WTD 180 (2002)

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition For Correction of )	<u>D E T E R M I N A T I O N</u>
Assessment of )	
)	No. 01-185
)	
... )	Registration No. . . .
)	FY . . . /Audit No. . . .
)	Docket No. . . .

RCW 82.04.160, RCW 82.04.220, RCW 82.04.4283: B&O TAX -- LOANS -- CASH DISCOUNTS. Discounts given by a Taxpayer on loans it sells to investors, to increase the attractiveness of the investment's yield, are not allowable cash discounts.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

Taxpayer protests the disallowance of deductions from loan fees for discounts on loans sold to investors.<sup>1</sup>

FACTS:

Lewis, A.L.J. -- Taxpayer makes and sells loans. Taxpayer makes large loans to marginal borrowers and subsequently "fragments" the loans by breaking the loan up and selling portions of the loan to investors. To keep a fresh supply of money coming in, Taxpayer syndicates and resells the loans immediately after they are made. In general, Taxpayer makes its money not from collecting interest by holding the loan, but rather from the loan fees it collects up-front from the borrower. To attract investors, Taxpayer sells the loans at discounts thereby increasing the yield. For example, an investor might purchase a \$100,000 loan fragment for \$99,000. The investor by receiving the right to payment of \$100,000 for \$99,000 thus increases the investor's yield on the loan.

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

From an accounting standpoint, Taxpayer, after making a loan, would record a loan fee receivable. Taxpayer however, maintains that it did not recognize the loan fee as income when it was recorded. Rather, according to Taxpayer, the loan fee was recognized when the loan was resold to the smaller investors. The discounts given to small investors to increase the investors' yield reduced the amount of Taxpayer's loan fee income. Taxpayer recognized as income and paid service-other business and occupation ("B&O") tax on the net amount of the loan fee.<sup>2</sup> Taxpayer deducted the discount and paid tax on the net amount believing it was only taxable on the amount it received.

The Audit Division of the Department of Revenue ("Department") audited Taxpayer's books and records for the period January 1, 1996 through December 31, 1999. On October 4, 2000, the Department issued a \$ . . . assessment. Most of the tax difference resulted from the assessment of service-other B&O tax on the amount of discounts given on fragmented loans and taken as deductions against loan fee income. The Audit Division disallowed the deductions maintaining that the discounts were a non-deductible cost of doing business.

Taxpayer disagreed. On November 3, 2000, Taxpayer filed a petition contending the discounts it had taken from its gross receipts were cash discounts.<sup>3</sup>

#### ISSUE:

Whether discounts given by Taxpayer on loans it sells to investors, to increase the attractiveness of the investment's yield, are an allowable cash discount?

#### DISCUSSION:

The B&O tax is imposed on the "gross income of the business." RCW 82.04.220. Gross income of the business is defined in RCW 82.04.080 as:

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 term "value proceeding or accruing" is defined in RCW 82.04.090 as:

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<sup>2</sup> The net loan fee being the loan fee received from extending the large loan reduced by the discounts given to the smaller investors to increase the yield on the loan to them.

<sup>3</sup> At the hearing, Taxpayer's representative withdrew its challenge related to the service-other B&O tax assessed on amounts Taxpayer advanced for appraisal fees.

the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued. The term shall be applied, in each case, on a cash receipts or accrual basis according to which method of accounting is regularly employed in keeping the books of the taxpayer.

Taxpayer is in the business of making and selling loans. Taxpayer enters into a loan agreement with its customer/borrower. The agreement specifies the amount of the money borrowed, the length of the loan, the repayment schedule, the interest rate, and the amount of costs including loan fees. Taxpayer has a contractual legal right to receive repayment of the loan, interest, loan fees, and any other specified payments. The loan fees, interest, and other payments to Taxpayer are taxable income, unless specifically exempt under the law.

We do not agree with Taxpayer that the loan discount is a deductible cash discount. RCW 82.04.4283 allows a deduction for “cash discounts.” That statute provides:

In computing tax there may be deducted from the measure of tax the amount of cash discount actually taken by the purchaser. This deduction is not allowed in arriving at the taxable amount under the extractive or manufacturing classifications with respect to articles produced or manufactured, the reported values of which, for the purposes of this tax, have been computed according to the provisions of RCW 82.04.450.

RCW 82.04.160 defines the term “cash discount” that is used in RCW 82.04.4283. It means “a deduction from the invoice price of goods or charge for services which is allowed if the bill is paid on or before a specified date.” The deduction for cash discounts does not apply to Taxpayer’s loan discounts as the loan discounts do not meet the definition of cash discount as defined by RCW 82.04.4283 and RCW 82.04.160.

Taxpayer acknowledges that under the broad definition of “gross income of the business” it is taxable on the interest, loan fees, and any other payments it receives related to making the loan, unless specifically exempt under the law. The issue is whether it may deduct from its income the discounts it gives on the loans it sells.

Taxpayer alone determines whether and how much it will discount the loans it sells. Taxpayer’s discounting of the loans it sells does not alter or disturb the contractual right it has between itself and its borrower. The fact that Taxpayer chooses to discount the fragmented loans does not alter the fact that Taxpayer received the loan fee that the borrower was contractually obligated to pay.

Taxpayer’s business activities require the payment of certain costs, e.g. office rent, utilities, salaries, taxes. These non-deductible business expenses are paid out of the gross revenues of the business. Market conditions undoubtedly drive Taxpayer’s decision to discount the loans it repackages and sells. Based on the facts presented we agree with the Audit Division’s finding that the amounts Taxpayer discounts the fragmented loans is a nondeductible cost of doing business and not a reduction of the contractual right Taxpayer has for payment from its borrower.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 12<sup>th</sup> day of December 2001.