Cite as Det. No. 88-255, 6 WTD 123 (1988)

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

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

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 88-255
. . .	)	Registration No. . . .

[1] **RULE 224:** RULE 203 -- RCW 82.04.080 -- SERVICE B&O TAX -- AFFILIATED CORPORATIONS -- MANAGEMENT FEES. Amounts received by one corporation from an affiliated corporation for management fees are subject to the Service B&O tax.

[2] **RULE 211**: B&O TAX -- REIMBURSEMENTS -- COSTS -- GROSS INCOME OF BUSINESS. Amounts received by one corporation for expenses paid on behalf of a subsidiary do not qualify as "reimbursements" under Rule 111 unless the paying corporation is not primarily or secondarily liable for the fees or costs, other than as agent for the subsidiary.

[3] **RCW 82.04.4292**: B&O TAX -- DEDUCTION -- INTEREST ON LOANS SECURED BY 1ST MORTGAGE OR DEED OF TRUST -- ORIGINATION FEES. Loan origination fees which relate to loans primarily secured by first mortgages or deeds of trust on nontransient residential property, and which are based on a percentage of the principal amount and represent an interest yield adjustment charged on loans are deductible under RCW 82.04.4292. Loan fees which represent charges for set-up fees or other services are subject to Service B&O. Pacific First Federal Savings and Loan Association v. Commissioner, cited.

[4] **RULE 146 AND RCW 82.04.4292:** B&O TAX -- DEDUCTION -- INTEREST ON LOANS SECURED BY A 1ST MORTGAGE OR DEED OF TRUST -- GAIN ON SALE OF LOANS DISTINGUISHED. Service B&O applies to the gain from

the sale of loans as the gain is realized from the sale rather than for the use or forbearance of money.

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: October 20, 1987

NATURE OF ACTION:

The taxpayer, a savings and loan association, protests the assessment of service B&O on reimbursements for expenses paid on behalf of a subsidiary, on "loan origination fees," on gain on sale of loans, and on gain from loan servicing.

FACTS AND ISSUES:

Frankel, A.L.J. -- The taxpayer's records were examined for the period January 1, 1982 through September 30, 1985. The audit disclosed taxes and interest owing in the amount of $ . . . . Assessment No. . . . for the total amount due was issued on May 29, 1986.

A post audit adjustment was made in which the taxpayer was given credit for disallowed deductions for GNMA certificates (Schedule II) and for loans secured by undeveloped land which was to be developed as nontransient residential property (Schedule III). The adjustment reduced the assessment to $ . . . .

The taxpayer protests the following assessment:

1) Income Reconciliation -- The taxpayer stated it was billed for and paid expenses which related both to itself and its subsidiary. It protests the assessment of B&O tax on the reimbursements for expenses paid to it by the subsidiary. It contends the expenses could have been paid out of the subsidiary's account.

2) Deduction of Loan Origination Fees -- The auditor denied deductions for the portion of loan fees that were recognized as income in the year the loan was made. He accepted the deduction for the portion of the fees that were deferred and amortized to produce a level interest yield over the expected life of the loan. The recognized portion was considered to represent non-deductible loan origination fees for costs associated with processing loans.

The taxpayer contends the total amount of the loan origination fee is deductible interest income. It stated that the loan fees are based on a percentage of the principal loan amount and adjust the yield on the loan. The taxpayer argues the loan fees have nothing to do with any services provided by the lender. Services are separately stated and charged to the borrower.

3) Gain on the Sale of Loans -- The taxpayer stated that the gain on the sale of loans consists of two types of sales. In one type, 100% of a loan is sold. In the other, the majority of the sales, the loan is partially sold. When a loan is sold, two entries are made. One entry recognizes the portion of the loan fee which had previously been deferred and the second entry represents the net present value (NPV) of the difference between the current market interest rate and the interest rate on the face of the loan.

The auditor concluded the gain was derived from the sale of the security, since its source was the portion of a loan that the taxpayer no longer owns. The taxpayer contends there is no difference between the amount of the loan origination fee which was to be amortized into interest income and the amount classified as gain on the sale of loans. The taxpayer's position is that since the total amount of the deferred loan origination fee that will be recognized is unchanged, the account in which it is recognized for internal bookkeeping purposes should have no effect on its deductibility.

The taxpayer contends the amount representing the NPV represents interest earned on loans primarily secured by first mortgages. The taxpayer explained the second entry as follows:

> The second entry reflects the fact that the portion of the loan sold will yield a lower interest rate than the portion of the unsold loan over the life of the loan. For example, the [taxpayer] will pay the purchaser of a 50% interest in a loan 9%, while the balance of the loan not sold will yield 10%. For record keeping purposes, the accounting rules dictate that the net present value of the interest rate differential be recognized immediately and that a deferred debit be set up on the balance sheet in a like amount. Since the interest income to be received in the future is currently recognized for accounting purposes, the deferred debit would then be amortized against the interest income as collections are received on the loan.

The issue is whether these amounts represent interest earned on loans that are primarily secured by first mortgages or trust deeds on nontransient residential properties, or whether the amounts are earned from the sale of securities.

4) Loan Servicing -- The taxpayer stated the loan servicing account consists of four types of entries for residential land. As of July 1985, the account includes commercial loans. The entries represent the following:

(1) Loan servicing fees for loans that were sold;

(2) additional interest from the retained portion of a loan that was partially sold, as described in "gain on sale of loans" above;

(3) the amortization of the NPV gain calculated under gain on sale of loans; and

(4) interest earned on a construction loan during a month before the loan is partially sold.

The taxpayer explained the fourth entry by the following example:

> The [taxpayer] underwrites a construction loan which allows the borrower to receive loan proceeds through the construction period as various phases of the residence are completed. If the [taxpayer] sells a portion of the construction loan to an investor, the investor is considered to own and is entitled to receive interest income only on the dollar amount which has been purchased. Generally the investor purchases and takes ownership of a portion of construction draws as of the last day of the month. Therefore, when the borrower draws $100,000 on the first of the month, the [taxpayer] owns and has a primary security interest in the mortgage or trust deed to the property until the last day of the month when the investor purchases a portion of the loan. 100% of the interest earned on these loans, from the time the [taxpayer] made the draw to the time the investor purchases the agreed upon portion of the loan, accrues to the [taxpayer] in the loan servicing account. It accrues in this account rather than interest income, due to the computer accounting program which allows allocation of interest on loans sold.

The taxpayer agrees that the first entry, loan servicing fees for loans that were sold, is taxable; but stated it already remitted Service B&O on those fees. It contends they should not be taxed twice.

The taxpayer contends the second, third and fourth entries are non-taxable to the extent they represent interest income from loans which are secured by first mortgages or trust deeds on nontransient residential properties.

The taxpayer stated that the income relating to residential properties was deducted for B&O tax purposes up until the end of June 1985 when a clerical error caused no deduction to be taken for the succeeding quarters. The taxpayer seeks an adjustment of the assessment to allow the deductions as reported in addition to deductions from July 1985 to December 1985 for those deductible items in the loan service income account.

DISCUSSION:

[1] Reimbursements -- At issue is the assessment of Service B&O on reimbursements for certain expenses paid by the taxpayer on behalf of a subsidiary. The expenses include lunch room expenses, building repair, equipment expenses, legal expenses, printing and supplies, telephone, postage, janitor, audit, director's compensation, and administrative fees paid to the taxpayer for its management activities on behalf of the subsidiary. The taxpayer contends reimbursements for expenses paid on behalf of a subsidiary are not subject to B&O tax, as they could have been paid out of the subsidiary's account.

The Service B&O tax is imposed by RCW 82.04.290 upon persons engaged in business activities other than or in addition to those for which a specific rate is provided elsewhere in Chapter 82.04 RCW. See also WAC 458-20-224. Such persons are taxable upon the "gross income of the business" defined in RCW 82.04.080 as:

> "Gross income of 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 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.

Clearly, the gross management fees received by the taxpayer from the subsidiary for its management services are subject to the Service B&O tax. Affiliated corporations are each a "person" within the meaning of Washington's Revenue Act. RCW 82.04.030 and WAC 458-20-203. Persons engaged in the rendering of personal services to others are taxable under the Service & Other classification upon the gross income of such business. WAC 458-20-138.

[2] The third-party costs are excludable from the taxpayer's income if the taxpayer is only a conduit for payment. The taxpayer must meet the requirements of WAC 458-20-111 (Rule 111). To be excludable, the taxpayer must not be primarily or secondarily liable for payment of the fees or costs, other than as agent of the affiliate. Reimbursements for third-party costs which are shared between the taxpayer and its subsidiary will be deductible if both the taxpayer and the subsidiary contracted for the services or the taxpayer contracted for the subsidiary's services as its agent.

As the Department stated in an earlier Determination:

> The Department of Revenue has consistently held that while closely related corporations are separate persons under the law and transactions between them are taxable to the same extent as if no special affiliation exists, where one corporation recovers the others share of costs for services rendered jointly to both by third person vendors and billed by such vendors, the receiving corporation is not "engaging in business" relative to such recovered amounts and that the Service business and occupation tax is not applicable to such payments. In these instances we are of the opinion that the receiving corporation merely recovers costs incurred primarily by its affiliates. However, where reimbursed amounts are received for actual services performed (or contracted to be performed but subcontracted to third persons) by the recipient, there is clearly a business activity involved and such amounts are subject to the imposition of excise taxes.

(Unpublished 1976 Determination). The Department's position is that the third party sales or services must be made jointly to all parties involved in order that a deduction may be claimed by the corporation paying the bill for shared expenses.

In this case, therefore, the assessment is upheld. The taxpayer has not provided any evidence that the costs or expenses were incurred by the subsidiary alone or by the taxpayer and the subsidiary jointly and the taxpayer was merely a conduit for payment.

[3] Loan Origination Fees -- Amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties are exempt from the B&O tax. RCW 82.04.4292. The primary issue raised in this appeal is whether the

taxpayer's "loan origination fees" are charges for interest and should be entitled to the deduction provided by RCW 82.04.4292, or whether the fees are in part a charge for services and therefore subject to Service B&O tax.

The term "interest" is not defined in the Revenue Act. A common definition of interest is that it is a charge for the use or forbearance of money, generally expressed as a percentage of the principal amount. In previous decisions, the Department has taken the view that no matter what designation is used, amounts received as compensation for the use of money, or for forbearance in demanding it when due, constitute interest. Discount points, for example, have been held to constitute "interest." This decision is in accordance with the treatment of points as interest for federal tax purposes. See IRC § 461 (g)(2) and Revenue Ruling 69-188, 1969-1 C.B. 54.

On the other hand, the Department has found that a loan origination fee charged by a lender to prepare loan documents, make credit checks, etc., represents consideration for the rendition of services incident to the creation of a mortgage rather than an amount for the use of money. Similarly, if a loan commitment fee is a nonrefundable fee paid by a prospective borrower to hold the terms of a loan for a stated period of time, the fee is consideration for an agreement to lend money and not for the use of money or for forbearance in demanding it when due. Consequently, we have found such loan fees do not constitute deductible interest.

Whether loan fees constitute deductible interest for purposes of RCW 82.04.4292 has not been addressed by the Washington courts. In Aetna Finance Co. v. Darwin, 38 Wn.App 921 (1984), the court found Aetna's loan funding fees were setup charges normally incidental to making a loan which must be treated as interest for usury purposes.[1] The court stated:

> Charges for making a loan and for the use of money are interest; charges are not interest if they are for services actually provided by the lender, reasonably worth the price charged, and for which the borrower agreed to pay.

38 Wn. App. at 926 (citation omitted).

In the present case, the taxpayer contends that the "loan origination fees" at issue are charges based on a percentage of the principal loan amount and adjust the yield on the loan. The fees are not for services provided by the taxpayer. Fees for services are separately stated and charged to the borrower.

For federal income tax purposes, 100% of the fees are deferred and amortized into taxable income over the life of the loans. The taxpayer recognized 1% to 2% of the loan fee in the current year and defers and amortizes the excess to produce a level interest yield over the expected life of the loan. The taxpayer contends this method was in accordance with Generally Accepted Accounting Principles (GAAP). The amount of the loan origination fee charged is tied to the loan interest rate. A borrower could pay a higher loan origination fee and receive a lower loan interest rate.

[1]Under RCW 19.52.020, a setup charge is exempt from characterization as interest only if it is made in connection with a loan of $500 or less.

The taxpayer relied in part on a federal tax court case, Pacific First Federal Savings & Loan Association v. Commissioner, 79 T.C. 512 (1982), in which the court considered similar facts and held loan origination fees charged in connection with loans were interest and not charges for services. As in the present case, Pacific First Federal Savings & Loan (PFF) designated the loan fee as a prepaid finance charge on its Federal Truth in Lending statements and added the fee to the interest rate in determining the annual percentage rate. The fee was treated as interest for purposes of determining compliance with State usury laws. PFF had accounted for its loan fees for federal income tax purposes on a deferred basis over the life of the loan, as it had accounted for stated interest. PFF also had reported the loan fees as exempt interest for B&O tax purposes. The Court noted that the Department had not challenged that treatment. 79 T.C. at 515.

The IRS argued that a portion of the loan fees was allocable to services, rather than an interest charge, and that amount should be reported in the year received rather than over the life of the loan. The Tax Court disagreed, holding that the loan fees were additional interest income.

The Court noted that whether a particular payment constitutes interest is determined by the facts, not by the terminology used and that the taxpayer had the burden of proof to show the fees were interest. The Court concluded that the following facts supported a finding that the loan fees were for additional interest rather than services:

(1) The loan fee rate was dependent upon the same factors relied on in determining the interest rate, namely the degree of risk involved and the current money market. The loan fee rate and interest rate were negotiable and were mutually dependent;

(2) No relationship existed between the cost in underwriting a loan and the loan fee charged thereon. This fact was supported by the fact that the loan fee was simply calculated as a percentage of the principal amount of the loan and no loan fee was charged if a loan did not close. Also, all of the third party costs incurred by PFF on a loan were charged to and paid by the borrower in addition to the loan fee, with the exception of escrow and appraisal services which were provided free of charge;[2]

(3) PFF consistently treated the loan fee as interest for purpose of complying with Federal Truth in Lending requirements and state usury and tax laws.

In the present case, the taxpayer stated the same facts are present and indicate all of the "loan origination fees" at issue represent an interest yield adjustment and not a charge for services. We agree. The fact that the taxpayer recognized 1% to 2% of the loan fee in the current year in accordance with the financial accounting standard in effect at that time is not controlling as to the

[2] PFF stated these services were provided free of charge to keep a competitive edge over the other savings and loan institutions which did charge for such services. The IRS argues the loan fee was a hidden charge for such services. The Court considered the fact that the loan fee remained the same whether or not third party escrow or appraisal services were used and the amount of the loan fee was competitive with the amount charged by similar institutions which charged separately for the third party services. In the present case, the taxpayer stated are services are separately stated and charged to the borrower.

nature of the income.

Furthermore, in 1986 the Financial Accounting Standard Board (FASB) issued Statement No. 91 which revised the original position and provides that loan origination fees shall be deferred and recognized over the life of the loan as an adjustment of yield, i.e. as interest income. The practice of recognizing a portion of loan origination fees as revenue in the first year to offset all or part of the costs of origination is no longer acceptable. (The statement applies to transactions entered into in fiscal year beginning December 5, 1987.)

In conclusion, we find that loan origination fees which relate to loans primarily secured by first mortgages or deeds of trust on nontransient residential property and which are not for services rendered but which represent an interest yield adjustment charged on loans are deductible under RCW 82.04.4292. The facts discussed above which the tax court relied on in Pacific First Federal will support a finding that loan fees are interest for B&O tax purposes also.

[4] Gain on Sale of Loans and Loan Servicing Account -- The taxpayer contends there is no difference between the amount of the loan origination fee which was to be amortized into interest income and the amount classified as gain on the sale of loans. We disagree. As the auditor's report stated, the Department's position is that the gain is from the sale of a security, as its source is the portion of the loan the taxpayer no longer owns. The gain is not from "interest received" from loans primarily secured by first mortgages or deeds of trust on nontransient residential property if it is a gain recognized from the sale of a portion of the loan. The portion of the money originally lent by the taxpayer is recovered when that portion is sold to a third party. The taxpayer and the third party who has purchased a participation are required to report interest income only in proportion to their investment in the loan. ETB 463.04.146. A corollary of this requirement is that each should be able to deduct interest income under RCW 82.04.4292 in proportion to their investment.

As we stated in Determination 86-267, 1 WTD 241 (1986) (. . .):

> The assignment for a consideration of the right to receive payments on a loan is a sale of an intangible. The selling of intangible assets is a business activity which does not fall within any of the specific business and occupation tax classifications enumerated in Chapter 82.04 RCW. Accordingly, it is taxable under the Service and Other Activities classification measured by the gross income of the business. RCW 82.04.290.

We relied on the definition of "gross income of the business" defined in RCW 82.04.080 which is quoted above, finding the assignment of the right to receive payments on a loan by the originating bank constitutes trading in evidences of indebtedness. If loans are sold for more than their face amount, then there are "gains realized" from such trading in evidences of indebtedness.

Accordingly, the assessment in Schedule VII is affirmed.

The auditor also assessed Service B&O on the loan servicing account, concluding the income also was derived from a sale of a security. The taxpayer contends the account represents interest from loans secured by a first mortgage on nontransient residential property and should be deductible no

matter how recorded for GAAP purposes.

The interest earned on the portion of the loan that was retained by the taxpayer is deductible, but not the interest differential from the portion of the loan that was sold. If the taxpayer sells a portion of a loan at a discount, the interest differential is not "derived from" interest recovered on a loan secured by a first mortgage on nontransient residential property, but from the sale of a portion of the loan for a lower interest rate.

The taxpayer also stated it had paid Service B&O tax on the loan servicing fees that were sold (4(1) above) and that the entries representing the amortization of the gain were taxed twice (Schedules VI and in VII). If the taxpayer's records document these assertions, the assessment shall be corrected. We agree that the loan servicing fees and gain should not be taxed twice.

As to the fourth entry under loan servicing described in the statement of facts above, we agree that if those amounts represent interest earned on a construction loan for nontransient residential property during a month before the loan is sold, the interest is "derived from" interest deductible under RCW 82.04.4292. If the taxpayer's records support its contention, the assessment of tax on this income shall be cancelled.

DECISION AND DISPOSITION:

1) The assessment of Service B&O in Schedule II is sustained unless the taxpayer provides additional evidence supporting a deduction as provided herein;

2) The assessment in Schedule III on loan fees is cancelled;

3) The assessment in Schedule VI on loan servicing shall be adjusted to delete the tax on loan servicing fees for which the taxpayer paid Service B&O tax, on any amounts which represent gain that is included in Schedule VII, and on interest earned on a construction loan during a month before the loan is partially sold as discussed above; and

4) The assessment of tax on gains from sales of loans and participation in Schedule VII is sustained.

The taxpayer shall provide any evidence supporting a deduction in Schedule II or adjustment to Schedule VI or VII to the auditor by July 20, 1988.

A new assessment shall be issued and due on the date provided thereon.

Any evidence which the taxpayer is not able to provide to the auditor within the 20-day period, but which it believes meets the guidelines for exclusion, may be presented to the Audit Division with a petition for refund. A petition for refund must be within the four-year limitation period provided by RCW 82.32.060.

DATED this 29th day of June 1988