Cite as Det No. 98-218, 18 WTD 46 (1999)

BEFORE THE 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. 98-218
. . .	)	Registration No. . . .
	)	FY . . . /Audit No. . . .

[1] RULE 146; RCW 82.04.4292: B&O TAX-- REQUIREMENTS. The person claiming the B&O tax deduction under RCW 82.04.4292 must meet all five elements of the statute.

[2] RULE 146; RCW 82.04.4292: B&O TAX-- INTEREST DEFINED. Interest is defined as the charge for the use or forebearance of money. This definition includes, but is not limited to, amounts charged to borrowers for the use of money over time. However, time is not an element of interest as defined.

[3] RULE 146; RCW 82.04.4292: B&O TAX-- ADJUSTMENT TO YIELD -- LOAN ORIGINATION FEES -- INTEREST. To the extent that a loan origination fee is treated as an adjustment to yield, it is interest. The portion of a loan origination fee not treated as an adjustment to yield is a fee for service and is not interest.

[4] RULE 146; CHAPTER 82.04 RCW; RCW 82.04.4292: B&O TAX-- TRANSACTIONAL TAX -- GAIN ON SALE -- PREVIOUSLY UNAMORTIZED LOAN ORIGINATION FEES. The B&O tax is a transactional tax. See Nordstrom Credit, Inc. v. Department of Rev., 120 Wn.2d 935, 942, 845 P.2d 1331 (1993). The granting of a loan and the sale of that loan are two separate transactions. The portion of loan origination fees treated as an adjustment to yield and not recognized until the loan is paid or sold, is not converted from interest to "gain on sale" of the loan. It remains interest. OVERRULING: Det. No 88-255, 6 WTD 123 (1988), and Det. No. 89-452, 8 WTD 209 (1989) on this point.

[5] RULE 146; RCW 82.04.4292: B&O TAX -- FACTORS TO DETERMINE IF A FEE IS INTEREST. A fee may be interest when: There is a legally enforceable

obligation of the debtor to pay the creditor; the debtor makes the payment or the payment is made on behalf of the debtor; and the payment is not for specific services such as a finder's fee, document preparation, title examination fees, notary fees, etc.

[6] RULE 146; RCW 82.04.4292: B&O TAX -- INTEREST -- SERVICES. To the extent a fee charged to a borrower is for a combination of services and compensation for the use or forebearance of money, the fee will be allocated between service income and interest income.

[7] RULE 146; RCW 82.04.4292: B&O TAX -- LOAN -- INVESTMENTS -- OWNERSHIP -- RISK -- INTEREST RATE FLUCTUTATIONS. Only interest received on the taxpayer's loans or investments qualifies for RCW 82.04.4292 deduction. Whenever a person makes a loan or an investment, the person assumes certain risks. When a person makes a loan or invests in a loan, the primary risk affecting the value of the loan or investment is interest rate fluctuation.

[8] RULE 146; RCW 82.04.4292: B&O TAX -- SALE OF LOAN -- RETAINED SERVICING RIGHTS. Once a taxpayer sells a loan, the receipt of servicing fees is a separate transaction from the granting of the loan. Loan servicing services are provided to the purchaser of the loan. The servicing fees are not derived from the servicer's loan or investment; rather they are fees for services. OVERRULING Det. No. 92-392, 12 WTD 535 (1992), in part, on this point.

[9] RULE 146; RCW 82.04.4292: B&O TAX -- SALE OF LOAN -- RETAINED SERVICING RIGHTS. When a loan is sold and the seller retains the servicing rights, the value of the retained servicing rights is not part of the measure of gain on sale. OVERRULING: Det. No. 90-141, 9 WTD 280-29 (1990) on this point.

[10] RULE 146; RCW 82.04.4292: B&O TAX -- FACTORS TO DETERMINE A TAXPAYER'S LOAN OR INVESTMENT -- INTEREST -- DEDUCTION. The only person entitled to the deduction is the owner of the loan or investment. The owner of a loan or investment is the party who is entitled to receive the principal of the loan. Stated another way, the owner of the loan or investment is the person who retains the risk of interest rate fluctuations.

[11] RULE 146; RCW 82.04.4292: B&O TAX -- FEES -- PURE MORTGAGE BROKER -- LOAN -- INVESTMENT -- INTEREST. Fees received for providing pure mortgage broker services are not deductible under RCW 82.04.4292 because the pure mortgage broker has not made the loan or investment.

[12] RULE 146; RCW 82.04.4292: B&O TAX -- FEES -- CORRESPONDENT BROKER -- LOAN -- INVESTMENT -- INTEREST. Fees received for providing correspondent broker services are not deductible under RCW 82.04.4292 because the correspondent broker is merely the agent for the correspondent bank, which bears the risk of interest rate fluctuation.

[13] RULE 146; RCW 82.04.4292: B&O TAX -- SPECIFIC FEES -- LENDING BROKER -- INTEREST -- DEDUCTION. Fees a lending broker receives for specific services provided by the lending broker are not interest and not deductible as such.

[14] RULE 146; RCW 82.04.4292: B&O TAX -- LOAN ORIGINATION FEES -- LENDING BROKER. Gross loan origination fees less direct loan origination costs result in net loan origination fees, which a lending broker receives as interest under FASB 91 and which are deductible under RCW 82.04.4292. Costs related to specific services, which are separately charged to the borrower, are not considered in calculating direct loan origination costs.

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:

A mortgage broker protests the Department of Revenue's denial of the RCW 82.04.4292 deduction from its business and occupation (B&O) tax for loan origination fees received on loans it brokered between the borrower and the lender. Additionally, the taxpayer protests the denial of the deduction on loans that were closed in the taxpayer's name and sold on the secondary market. [1]

FACTS:

Coffman, A.L.J. -- The taxpayer is a licensed mortgage broker. The Audit Division of the Department of Revenue (Department) reviewed the taxpayer's books and records for January 1, 1990 through December 31, 1993.

1. **Loan Origination Fees (LOFs).**

The taxpayer's primary business activity is facilitating home mortgages[2]. The taxpayer explained that this activity occurs in three separate types of scenarios where the taxpayer acts as:

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

[2] For the purposes of this determination, the term "mortgages" includes "deeds of trust".

a "pure mortgage broker", a "correspondent broker", or a "lending broker".[3] In all three scenarios, the taxpayer prepares all paperwork relating to the home mortgage application, obtains the necessary reports (i.e., credit reports, title searches, etc.), and receives the LOF charged to the borrower.

In the "pure mortgage broker" scenario, the taxpayer brings a potential borrower (homeowner) together with potential lenders. The taxpayer submits the entire home mortgage application package to lenders for their consideration. If a lender approves, it lends the agreed portion of the purchase price directly to the homebuyer. The taxpayer is paid a LOF from the buyer's escrow account at closing, that is, when the homeowner's purchase of the home is completed.

In the "correspondent broker" scenario, the taxpayer's role is slightly different: the loans are closed in the taxpayer's name[4]. The correspondent broker is required by its agreement with the lender to transfer the loan to the lender or to its designee.[5] The taxpayer retains all, or a portion of, the LOF paid by the borrower at closing. We refer to the taxpayer's role in this type of transaction as a "correspondent broker" and the lender as a "correspondent bank".[6] This type of transaction is also identified as "table funding".

In the "lending broker" scenario, the taxpayer funds the loan using a line of credit (or cash reserves) and sells the loan on the secondary market. In this scenario, the taxpayer is not required to sell the loan to the provider of the line of credit. The loans may be sold at par[7], or not, depending upon the interest rate stated in the note.

The taxpayer did not pay B&O tax on the LOFs it received during the first three quarters of 1990, but did pay B&O tax on all LOFs it received during the remainder of the audit period. The

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[3] **The terms "pure mortgage broker", "correspondent broker", and "lending broker" were not used by the taxpayer. They are terms we have adopted for our own use in this determination for the purpose of clarity only, and are not to be construed as having any meaning other than the meaning we attach to them herein.**

[4] The taxpayer identified loans guaranteed by the Federal Home Administration or the Veteran's Administration as falling into this scenario. We understand it is common practice for the lender to place the loan proceeds in escrow pending the closure of the real estate purchase. Whether the taxpayer's correspondent broker activities were conducted through the use of an escrow is unknown. For the reasons stated below, it is unnecessary to determine if the correspondent banks used an escrow.

[5] The transfer may be to a third party on the secondary market. The secondary market includes sales through FannieMae, FreddieMac, and other government supported programs.

[6] Financial Accounting Standards Board Statement 65 (FASB 65) defines "mortgage banking enterprise" as:

> An enterprise that is engaged primarily in originating, marketing, and servicing real estate mortgage loans for other than its own account. [Pure Mortgage Broker] Mortgage banking enterprises, as local representatives of institutional lenders, act as correspondents between lenders and borrowers. [Correspondent broker].

(Bracketed material added.)

[7] "Par" means "a condition of equality between the face value of a negotiable instrument, as a stock or bond, and its current market value." Webster's II New Riverside University Dictionary, 1988, page 851.

Audit Division assessed B&O tax on the LOFs the taxpayer did not report during the first three quarters of 1990. It assessed the tax because it found the LOFs did not constitute interest and were not deductible from the measure of the B&O tax under RCW 82.04.4292. The taxpayer disagrees, claiming the LOFs are interest and, therefore, deductible. The taxpayer petitions for a cancellation of B&O tax assessed for 1990 and a refund of the B&O tax it paid on the LOFs during the remainder of the audit period.

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ISSUE:

1. Is the RCW 82.04.4292 deduction available to a mortgage broker for its receipt of LOFs?

DISCUSSION:

Because of the extensive discussion and length of this determination, we believe it is useful for the reader to have an understanding of the approach we are taking. First, we will address whether the taxpayer qualifies for the RCW 82.04.4292 B&O tax deduction by discussing: (1) The five elements of the deduction; (2) The definition of interest; (3) Tests the Department uses to determine if amounts a taxpayer receives are interest or a fees for a service; (4) Who is entitled to take the deduction; and (5) Tests the Department uses to determine if the taxpayer is that person. After establishing the tests, we will address each of the three scenarios separately. . . .

1 Is the RCW 82.04.4292 deduction available to a mortgage broker for its receipt of LOFs?

A. What are the five elements of the business and occupation tax deduction under RCW 82.04.4292?

The taxpayer contends LOFs constitute interest and as such are deductible from gross income under RCW 82.04.4292, which states:

> In computing tax, there may be deducted from the measure of tax by those engaged in banking, loan, security or other financial businesses, amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties.

[1] The statute identifies five elements of the RCW 82.04.4292 deduction. All five elements must be present.[8] The person claiming this deduction must meet all following five conditions:

1. The person is engaged in banking, loan, security, or other financial business;
2. The amount deducted was derived from interest received;
3. The amount deducted was received because of a loan or investment;
4. The loan or investment is primarily secured by a first mortgage or deed of trust; and
5. The first mortgage or deed of trust is on nontransient residential real property.

See Det. No. 92-392, 12 WTD 535 (1992) and Det. No. 93-086, 12 WTD 603 (1993) (Where the Department identified these elements in a similar manner).

For the purposes of this determination, the taxpayer satisfies the first, fourth, and fifth elements. Thus, only the second and third elements are in dispute.

B. Definition of Interest.

i. General Discussion:

The term "interest" is not defined in RCW 82.04.4292. Further, it is not defined in any tax statute in Title 82 RCW nor in any rules promulgated by the Department. Det. No. 92-392, supra. Resolution of this case demands such a definition.

[2] In Security Savings Soc. v. Spokane Cty., 111 Wash. 35, 37, 189 Pac. 260 (1920)[9], the court said "Interest is merely a charge for the use or forbearance of money." Similarly, BLACK'S LAW DICTIONARY 950 (4th ed. 1968) defines interest as: "[T]he compensation allowed by law or fixed by the parties for the use or forebearance or detention of money." In Det. No. 88-255, 6 WTD 123 (1988), we said that interest is the "charge for the use or forebearance of money, generally expressed as a percentage of the principal amount." (Emphasis added.) Thus, amounts charged to borrowers over time, as a percentage of the outstanding balance of the loan, are interest. While this type of interest includes a time element, we note that the interest definitions quoted above do not include a time element.

Similarly, the Internal Revenue Service issued Revenue Ruling 69-188, 1969-1 C.B. 54, stating for the purposes of federal income tax[10] that:

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[8] Deductions are narrowly construed against the taxpayer. Budget Rent-A-Car, Inc. v. Department of Rev., 81 Wn.2d 171, 500 P.2d 764 (1972).

[9] This case involved the amount of interest due on a tax certificate.

[10] Although Internal Revenue Service rulings and federal income tax decisions are not binding on the application of RCW 82.04.4292, we find that they consistent with the Department's position.

> [I]nterest has been defined by the Supreme Court of the United States as the amount one has contracted to pay for the use of borrowed money, and as the compensation paid for the use or forbearance of money. See Old Colony Railroad Co. v. Commissioner, 284 U.S. 552 (1932), Ct.D. 456, C.B. XI-1, 274 (1932); Deputy v. Dupont, 308 U.S. 488 (1940), Ct.D. 1435, C.B. 1940-1,118. The Board of Tax Appeals [now the U.S. Tax Court] has stated that interest is the compensation allowed by law or fixed by the parties for the use, forbearance, or detention of money. Fall River Electric Light Co. v. Commissioner, 23 B.T.A. 168 (1931). A negotiated bonus or premium paid by a borrower to a lender in order to obtain a loan has been held to be interest for Federal income tax purposes. L-R Heat Treating Co. v. Commissioner, 28 T.C. 894 (1957).
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> The payment or accrual of interest for tax purposes must be incidental to an unconditional and legally enforceable obligation of the taxpayer claiming the deduction. Paul Autenreith v. Commissioner, 115 F.2d 856 (1940). There need not, however, be a legally enforceable indebtedness already in existence when the payment of interest is made. It is sufficient that the payment be a "prerequisite to obtaining borrowed capital." L-R Heat Treating Co. v. Commissioner.
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> To qualify as interest for tax purposes, the payment, by whatever name called, must be compensation for the use or forbearance of money per se and not a payment for specific services which the lender performs in connection with the borrower's account. For example, interest would not include separate charges made for investigating the prospective borrower and his security, closing costs of the loan and papers drawn in connection therewith, or fees paid to a third party for servicing and collecting that particular loan.

(Bracketed material added.) We have relied on Rev. Rul. 69-188 as persuasive authority. See Det. No. 88-255, supra, and Det No. 89-820, 7 WTD 375 (1989). Further, the Federal Court of Claims in a federal income tax case distinguished interest from a brokerage fee because the brokerage fee:

> was in consideration of services rendered by Lehman, it was not "compensation paid for the use or forbearance of money" -- that is, it was not interest. In addition, the fact that although Lehman retained the fee he did not lend any of his own funds to the plaintiffs, confirms that the payment was for services, not for the use of money.

Duffy v. The United States, 231 Ct. Cl. 679, 690; 690 F.2d 889 (1982) (Citations omitted.). See also Goodwin v. Commissioner, 75 T.C. 424, 440-441 (1980), affd. without published opinion 691 F. 2d 490 (3rd Cir., 1982). ("Fees paid for services performed by a lender in connection with a loan are not interest.")

Likewise, in the usury[11] context, the Washington Court of Appeals stated that "[c]harges 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." Aetna Finance Co. v. Darwin, 38 Wn.App. 921, 926, 691 P.2d 581 (1984). In Lincoln v. Transamerica Investment, 89 Wn.2d 571, 576, 573 P.2d 1316, (1978), the court said:

> Every amount paid to a lender is not necessarily for the use of money. The courts of this state have recognized that payment for services is not payment for the use of money (Peoples Nat'l Bank v. National Bank of Commerce, 69 Wn.2d 682, 420 P.2d 208 (1966)) and that a 'finder's fee' may indeed be referable to services rendered rather than to compensation for the loan of money.

These cases consistently hold that fees for services are not interest. We are unable to find any compelling reason not to follow the logic used by these courts in this determination.

ii. Published Determinations:

The Department's published determinations concerning what is interest for the purposes of RCW 82.04.4292 can be divided into three categories: The first and second categories concern fees for services versus interest and the measure of gain on sale. The third category generally covers who is entitled to the deduction.

a. Fees versus service.

Fees charged by lenders for specific services are not interest. These include: loan commitment, brokerage, and loan set-up fees (Det. No. 89-280, supra); servicing fees (Det. No. 88-255, supra); and document preparation and correspondent fees (Det. No. 94-92, 14 WTD 251 (1994)).

[3] Likewise, we have ruled a LOF, to the extent it is treated as an "adjustment to yield"[12], is interest. Det. No. 88-255, supra. But amounts, which are not amortized as an adjustment to yield, are fees for services. Id. In reaching this conclusion, we relied on FASB 91. Specifically, we cited

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[11] Although usury cases are not binding on the Department's definition of interest, we find they are consistent with the federal income tax cases and ruling, cited above.

[12] Financial Accounting Standards Board Proclamation 91 (FASB 91) explains the term "adjustment to yield" as

> Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method …. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization.

FASB 91 for the proposition that the portion of a LOF used for direct loan origination costs represents a fee for services. We concluded:

> The Department is not taking the position that under the City Mortgage[13] case referred to above, the total amount of charges labeled "loan fees" represents charges for services and no portion is deductible interest. Instead, the Department will consider the substance of the charges, but the taxpayer has the burden of proof to show that the charges represent interest and not charges for services. This burden is not met if the charges are for services, as underwriting or direct loan origination costs, and are recognized as income on the taxpayer's books. In the present case, therefore, if part of the fees were recognized as income as direct costs of loan origination, such amounts do not constitute deductible interest.

Det. No. 89-280, supra. (Footnote added.) Thus, when a fee is charged for a specific service, the fee is not interest.

b. Gain on sale of loans.

The gain on the sale of a loan is not interest. Det. No. 89-445, 8 WTD 181 (1989). Because interest must be paid by the borrower, premiums, such as service release premiums, paid by the secondary market purchaser to the seller of a loan are part of the measure of the gain on sale. Det. No. 89-452, 8 WTD 209 (1989). See also Det. No. 89-474, 8 WTD 259 (1989).

In Det. No. 88-255, supra, and Det. No. 89-452[14], supra, we found the previously unamortized portion of LOFs[15] was part of the measure of the gain on the sale of a loan. Conversely, in a more recent determination, under the same facts, we stated previously unamortized LOFs were not received as the result of the sale of the loan. Det. No. 92-392, supra. These decisions are irreconcilable. We find the reasoning of Det. No. 92-392, supra, to be correct.

[4] The B&O tax is a transactional tax.[16] There were two transactions in Det. No. 88-255, supra, Det. No. 89-452, supra, and Det. No. 92-392, supra: making loans; and, selling those loans. The previously unamortized LOFs were received for making the loan, not for selling the loan. The previously unamortized LOFs are not received as the result of the sale, therefore, they can not be part of the measure of the gain on sale. This is true despite the taxpayer combining the proceeds of the sale with the previously unamortized LOFs into a single bookkeeping entry entitled “gain on sale”.

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[13] City Mortgages Services, Inc. v. State of Wash., Dept. of Rev., Docket No. 83-2-01420-1, Thurston County Superior Court (1986).

[14] In Det. No. 89-452, the previously unamortized LOFs were recorded in the taxpayer’s books and records as “service release premiums”.

[15] Unamortized LOFs are the portion of the LOFs that have not been recognized as income by the taxpayer.

[16] See Nordstrom Credit, Inc. v. Department of Rev., 120 Wn.2d 935, 942, 845 P.2d 1331 (1993) (The court said, “Florida taxes income, while Washington taxes transactions.”).

Further, we find no distinction between selling a loan and the borrower paying a loan in full prior to maturity. In both cases, the lender recognizes the previously unamortized LOFs. However, Det. No. 88-255, supra, treats the two transactions differently. To the extent Det. No. 88-255, supra, and Det. No. 89-452, supra, treat previously unamortized LOFs as gain on sale, they are overruled.

c. Factors considered in determining if a receipt is interest.

[5,6] Based upon the foregoing, we consider the following factors in determining whether a payment is interest.

1. There must be a legally enforceable obligation of the debtor to pay the creditor. Rev. Rul. 69-188, supra. For example, usury, statute of limitations, or other statute must not bar the payment.

2. The debtor must have made the payment or the payment was made on behalf of the debtor. Det. No. 89-452, supra. Thus, the gain from the sale of loans is not interest. Det. No. 89-461, 11 WTD 21 (1989), Det. No. 89-474, Det. No. 94-92, supra.

3. The payment must not be for specific services such as a finder's fee, document preparation, title examination fees, notary fees, etc.[17] Duffy v. The United States, 231 Ct. Cl. 679; 690 F.2d 889 (1982); Goodwin v. Commissioner, 75 T.C. 424, (1980), affd. without published opinion 691 F. 2d 490 (3rd Cir., 1982); Aetna Finance Co. v. Darwin, supra; and Lincoln v. Transamerica Investment, supra. To the extent a fee charged to a borrower is for a combination of services and compensation for the use or forebearance of money, the fee will be allocated between service income and interest income. Det. No. 92-392, supra. See also FASB 91.

C. What is a qualifying loan or investment?

[7] Only interest received on the taxpayer's loans or investments qualifies for RCW 82.04.4292 deduction. Det. No. 90-141, 9 WTD 280-29 (1990), Det. No. 89-474, supra. This finding is implicit in the statute.[18] In Det No. 89-445, supra, we found:

[17] The term "finance charge", as used in the Truth in Lending Act and Regulation Z (12 C.F.R § 226), is broader in scope than the term "interest" and therefore is not relevant in defining interest for Washington tax purposes. Regulation Z defines the term "finance charge" and provides examples of charges included therein. For example, "Appraisal, investigation, and credit report fees" are part of the finance charge. Reg. Z. § 226.4(b)(4). These charges are not interest under Washington law. See, e.g., Aetna Finance, supra; Lincoln, supra.

[18] Similarly, other deduction statutes, implicitly require investments to be made by the person claiming the deduction. For example, RCW 82.04.4281 provides a deduction to non-financial businesses for amounts derived from investments or the use of money. It does not specifically state the investment or money must belong to the person taking the deduction, but is implied. See also RCW 82.04.4293 (deductibility of interest on loans to the State of Washington and political subdivisions) and RCW 82.04.4294 (Deductibility of interest on loans to farmers, ranchers, etc.)

> because … mortgage-backed securities are primarily secured by residential mortgages, interest payments to owners of such securities, or participations in them, are exempt[19] under the business and occupation tax under RCW 82.04.4292.

(Footnote added. Emphasis added.)

Whenever a person makes a loan or an investment, the person assumes certain risks. When a person makes a loan or invests in a loan, the primary risk affecting the value of the loan or investment is interest rate fluctuation. If the market interest rates decrease, the value of the loan or investment will increase. Likewise, if market interest rates increase, the value of the loan or investment will decrease.

[8] Generally, when a lender sells a loan and retains a portion of the interest payments, we have found the retained interest payment is not deductible under RCW 82.04.4292. In such cases, the buyer continues to make payments to the seller. The seller continues to maintain the records of the payments and the escrow account to pay real property taxes, insurance premiums, and other agreed to costs. Further, the seller forwards the principal and most of the interest to the buyer of the loan. These are separate business transactions (sale of the loan and servicing of the loan) and are separately taxed. See Nordstrom Credit, Inc., supra. The taxpayer receives a fee for services it provides to the purchaser of the loan. This fee was not derived from the taxpayer's loan or investment; rather it was a fee for services. We have failed to uniformly address these receipts in the past.

In Det. No. 92-392, supra, we held the taxpayer's retention of the interest after selling the principal of the mortgages it had originated continued to be deductible interest from its loan or investment. However, in Det. No. 90-141, supra, we found the taxpayer's retention of a portion of the interest was a premium on the sale and part of the measure of the gain on sale. See also Det. No. 88-255, supra. We find both conclusions were incorrect.

In Det. No. 92-392, supra, the taxpayer received a return of its investment and provided a service to the purchasers of the loans. We held the taxpayer continued to have an investment in the loan after selling it, concluding that the Department's Excise Tax Bulletin (now Excise Tax Advisory[20]) 463.04.146 (ETA 463) did not require

> an allocation of interest income according to the amount of original principal held. Instead, the ETB is recognizing the differing ownership rights of the originating lender

[19] This quote is misleading where it states the interest income is exempt from the B&O under RCW 82.04.4292. Technically, interest is not exempt under this statute; rather it must be included as gross income and reported as such, but a deduction may be taken from gross income when calculating and reporting B&O tax due. This is harmless error because there is no effect on the total tax liability. Thus, we find no need to further modify the application of Det. No. 89-445, supra.

[20] The Department recently cancelled all Excise Tax Bulletins (ETB) and reissued them as Excise Tax Advisories. Thus, references to ETBs in published determinations now refer to ETAs.

> and the investor and requiring an apportionment of the interest income in accordance [with sic] the respective ownership of each.

We failed to properly interpret ETA 463 in Det. No. 92-392, supra. Specifically, we failed to consider the risk of interest rate fluctuations. The taxpayer in Det. No. 92-392, supra, would not gain or suffer a loss if the market interest rate changed. In Det. No. 89-474, supra, we analyzed ETA 463 and said:

> Although not dispositive of this case, the [ETA 463] is instructive in that those parties whose money is actually being used by the borrower (i.e., the party which owns the loan and the party who has purchased a participation) are required to report interest income only in proportion to their investment in the loan. It follows that if there is no longer an investment by a taxpayer, no interest should be reported, and thus no RCW 82.04.4292 deduction would apply.
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> When a loan is transferred to the parent, the taxpayer receives a full return on its funds since the full face value of the loan has been received in exchange. The taxpayer no longer has an investment in the loan, and its money is thus not being used by the borrower. We would thus be hard pressed to hold that the additional premium received by the taxpayer is in the nature of interest, since the taxpayer's money is in fact not being used by the borrower.
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> The premium received by the taxpayer in this case is not an amount derived from "interest received" simply because the taxpayer receives a premium or a premium receivable. The premium in this case is not "interest," or compensation for "the use or forbearance" of the taxpayer's money, since the money originally lent by the taxpayer has already been fully recovered by virtue of the taxpayer's parent having purchased the loan in its entirety.

(Emphasis and bracketed material added.) We find Det. No. 89-474, supra, is correct. We overrule the portion of Det. No. 92-392 at 12 WTD 543-9, which is inconsistent with Det. No. 89-474, supra.

[9] While the result in Det. No. 90-141, supra, was partially correct (the portion of the interest payment retained is not deductible), we reached this conclusion on the wrong legal basis. The taxpayer in Det. No. 90-141, supra, sold the principal and most of the interest of loans for a lump sum amount, but retained a portion of the interest payments for servicing the loan. We held the portion of the interest payment retained was subject to service and other activities B&O tax as gain on sale of the loan. As stated above, the fee is not a part of the measure of the gain on sale of the loan. The payment is still interest to the borrower, but it is not on the taxpayer's investment. Because we used an incorrect premise to sustain the tax, we hereby overrule Det. No. 90-141, supra, and Det. No. 88-255, supra.

[10] To summarize, the only person entitled to the RCW 82.04.4292 deduction is the owner of the loan or investment. The owner of a loan or investment is the party who is entitled to receive the principal of the loan. Det. No. 89-445, Det. No. 90-141, Det. No. 90-288, Det. No. 92-377, Det. No. 93-377, supra. See also Det. No. 89-460, supra, and ETA 463. Stated another way, the owner of the loan or investment is the person retains the risk of interest rate fluctuations.

D. Application of tests to the three scenarios.

1. Pure Mortgage Broker -- Is the receipt by a mortgage broker of a fee for facilitating home mortgages between a borrower and a lending institution deductible under RCW 82.04.4292?

[11] For those loans where the taxpayer acts solely as a broker, the taxpayer meets with a potential borrower and obtains financial information from the borrower. The borrower deposits a specified sum with the taxpayer to use to pay third-party costs, arising out of the transaction. This payment is placed in a trust account pursuant to RCW 19.146.050.[21] After obtaining the necessary information from the potential borrower, the taxpayer prepares the loan application and "shops" the application with potential lenders. If the application is accepted by a lender and the loan closes, the taxpayer receives a fee for these services. The fee is usually designated as a "loan origination fee".

We look to the substance of the fee, not merely the label placed on it. Det. No. 89-280, supra, and Det. No. 90-141, supra. When the taxpayer acts as a pure mortgage broker, the taxpayer is receiving a fee for obtaining the loan for the borrower. This brokerage fee is indistinguishable from a finder's fee, which the courts in Duffy v. The United States. Supra, and Lincoln v. Transamerica Investment, supra, said was not interest. See also Det. No. 89-280, supra, in which we also held a similar finder's fee was not interest. Thus, the LOF in the pure mortgage broker scenario fails the second element of the RCW 82.04.4292 deduction.

Further, the taxpayer is not the party granting the right to use money. The taxpayer bears none of the risk of an interest rate decline. Therefore, the taxpayer's receipt of a LOF in this type of transaction also fails to meet the third element under RCW 82.04.4292, that is, the LOF is not derived from the taxpayer's investment or loan. The RCW 82.04.4292 deduction is not available to the taxpayer in pure mortgage broker situations.[22]

2. Correspondent Broker -- When a mortgage broker makes loans in its own name from funds provided by a correspondent bank and is required to transfer the loan to, or on behalf of, the same correspondent bank, has the mortgage broker acted merely as the agent for the correspondent bank?

[21] These amounts are not taxable to the taxpayer pursuant to Det. No. 92-393, 12 WTD 253 (1993) and Det. No. 94-92, supra.

[22] See also FASB 65 ¶ 24, which treats fees paid to pure mortgage brokers as "loan placement fees".

Again, we must look to the substance of the transaction and not merely its form. In these transactions, the taxpayer is identified on the closing documents as the lender. Thus, it appears the taxpayer has granted to the borrower the right to use money. However, the taxpayer is obligated to transfer the loan to, or on behalf of, the same lender who advanced it the funds. In these situations, we find the taxpayer was merely the agent for the lender and, as such, the taxpayer does not bear the risk of interest rate fluctuations.

The Washington Supreme Court said: "Agency requires that both parties consent to the relationship and that the principal exercises control over the agent." Nordstrom Credit, Inc., supra, at 941. The agreements between correspondent brokers and correspondent banks show there is consent by both parties.

Further, the correspondent bank only funds those loans it has previously approved. The correspondent broker must comply with the correspondent bank's guidelines and may not close the loans without prior approval. This constitutes sufficient control by the correspondent bank over the correspondent broker to establish that the correspondent broker acts only as the agent for the correspondent bank.

[12] The correspondent broker is not the true lender of funds to the borrower; rather, the correspondent bank is the true lender. The correspondent bank bears the risk of interest rate fluctuations and is entitled to receive repayment of the principle of the loan. The correspondent broker is not entitled the repayment of the principal and bears no risk of interest rate fluctuation. The correspondent broker is taxable in the same manner as the pure mortgage broker discussed above. Any fee it retains is neither interest nor derived from its investment and not deductible under RCW 82.04.4292.

3. Lending Broker – Do loan origination fees constitute interest, when a mortgage broker uses borrowed funds to make loans to the homebuyer and is liable for the repayment of those funds? And if so, are they deductible if all other conditions are met under RCW 82.04.4292?

The third type of loan transaction at issue in this appeal occurs when the taxpayer uses its line of credit or other funding source without the obligation to sell or assign the loan to the party providing the funding. In this situation, the taxpayer is the person advancing the funds to the borrower and bears the risk of interest rate fluctuations. The only issue is whether the fees received are interest under the test set out in § 1.B(ii)(c), above. There is no reason to believe the obligation of the debtor/borrower is unenforceable. Further, the LOFs are paid by the borrower or on the borrower's behalf. The lending broker's receipt of LOFs, as the lender in this type of transaction, meets the first two tests to qualify as interest for the purposes of the RCW 82.04.4292 deduction. That is, the LOFs are (1)-legally enforceable and (2)-the payment is made by, or on behalf of, the borrower. We must then determine if fees charged the borrower are for specific services or for the use or forebearance of money.

The taxpayer may charge the borrower various fees. These include specifically identified fees such as document preparation fees, set-up fees, title insurance, and credit report fees, as well as a LOF.

[13] The taxpayer's charges for third party costs (i.e., appraisals, title reports, credit reports, etc) are placed in a trust account.[23] As we said in Det. No. 94-92, supra, under the unique circumstances of a licensed mortgage broker, receipts for third party costs are not gross income of the business and therefore are not subject to the B&O tax. However, the fees for specific services the taxpayer directly provides such as document preparation and set up fees are not subject to RCW 19.146.050 and fail the third part of the interest test at § 1.B(ii)(c), above. Thus, the fees for specific services are part of the taxpayer's gross income and are not deductible under RCW 82.04.4292.

Historically, a LOF was charged to compensate a lender for preparing documents, evaluating the borrower's credit, evaluating debt to equity ratios, and similar activities. More recently, lenders have begun charging separately for each of these services. Further, some lenders do not charge LOFs, but charge minimum "points", and vice versa. Discounts or points may also be paid by borrowers to obtain a lower stated interest rate.[24]

FASB 91 acknowledges this difficulty in classifying LOFs. Paragraph 36 states:

> The Board received considerable comment about the variety of fees collected by a lender in connection with lending. The Board divided such fees for loan origination into two principal categories: (a) fees associated with origination of a loan and (b) fees associated with committing to lend. Origination fees consist of:
>
> a. Fees that are being charged to the borrower as "prepaid" interest or to reduce the loan's nominal interest rate, such as interest "buy-downs" (explicit yield adjustments)
> b. Fees to reimburse the lender for origination activities

[23] Per RCW 19.146.050, the taxpayer

> shall not in any way encumber the corpus of the trust account or commingle any operating funds with trust account funds. Withdrawals from the trust account shall be for the payment of bona fide services rendered by a third-party provider or for refunds to borrowers. Any interest earned on the trust account shall be refunded or credited to the borrowers at closing.

[24] The stated interest is the interest rate stated in the note. The taxpayer may offer mortgages at a stated interest of 7%. However, if the borrower is willing to pay an additional point (1% of the loan amount), the taxpayer will make the same loan with a stated interest rate of 6.875%. The interest rates stated in this footnote do not necessarily represent the actual rates charged by the taxpayer, but are given as an example only.

c. Other fees charged to the borrower that relate directly to making the loan (for example, fees that are paid to the lender as compensation for granting a complex loan or agreeing to lend quickly)

d. Fees that are not conditional on a loan being granted by the lender that receives the fee but are, in substance, implicit yield adjustments because the loan is granted at rates or terms that would not have otherwise been considered absent the fee (for example, certain syndication fees addressed in paragraph 11).

FASB 91 responds to these different types of LOFs by stating at ¶ 5:

> Loan origination fees shall be deferred and recognized over the life of the loan as an adjustment to yield (interest income). Likewise, direct loan origination costs, defined in paragraph 6 shall be deferred and recognized as a reduction in the yield of the loan except as set forth in paragraph 14 (for troubled debt restructuring). Loan origination fees and related direct origination costs for a given loan shall be offset and only the net amount shall be deferred and amortized. The practice of recognizing[25] a portion of loan origination fees as revenue in a period to offset all or part of the costs of origination shall no longer be acceptable.

(Footnote added.)

[14] We accepted the adjustment to yield analysis provided by FASB 91 in Det. No. 89-280 and Det. No 92-392.[26] We affirm this treatment – net LOFs (gross LOFs less direct loan origination costs) constitute interest. We note direct loan origination costs include:

> only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.

FASB 91, ¶ 6.

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[25] Recognition is the recording in the business' books and records the transaction as a current expense or income. The date of recognition may not be the same as the date of payment or receipt for accrual method taxpayers, but is the same date for cash basis taxpayers.

[26] In Det. No. 88-255, supra, we allowed the deduction of the amortized portion of the loan origination fees. We did not discuss the netting required by Paragraph 5 of FASB 91. Det. No. 88-255, shall not be interpreted as allowing 100% of loan origination fees to be deductible.

Where the taxpayer charges a borrower a document preparation fee or other specific non-interest fee, the costs associated with those fees are not part of the calculation of direct loan origination costs.

We are aware that FASB 91 paragraph 27(c) amends FASB Statement No. 65 to read:

> Loan Origination Fees and Costs
>
> If the loan is held for resale, loan origination fees and the direct loan origination costs as specified in FASB Statement No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, shall be deferred until the related loan is sold. If the loan is held for investment, such fees and costs shall be deferred and recognized as an adjustment of ***yield*** as specified in paragraphs 18-20 of Statement 91.

(Emphasis in original.) We interpret this paragraph as a practical application of Paragraph 5. It would constitute an extra cost for a lender to calculate the yield adjustment when the loan is intended to be sold within a short period of time. Therefore, it is sufficient to report all the income and expenses upon sale. However, that does not change the nature of the net LOF as interest.

Taxpayers have a duty to maintain their books and records to support any claimed deductions. RCW 82.32.070 and WAC 458-20-254(2)(a)(ii). Thus, if the taxpayer is unable to document its direct loan origination costs, it is not entitled to the RCW 82.04.4292 deduction. To summarize, when the taxpayer is a lending broker, the net LOFs (gross LOF less direct loan origination costs) are interest on the taxpayer's investment or loans.

. . .

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part. The file will be remanded to the Audit Division for the purpose of issuing a Post Assessment Adjustment.

1. In evaluating the taxpayer's receipt of fees, the taxpayer and the Audit Division may refer to the analysis of the three scenarios. Specifically, when the taxpayer acts as a pure mortgage broker, the taxpayer will be taxable on all amounts that it receives from the borrower.[27] Likewise, when the taxpayer acts as a correspondent broker, net amount retained by the taxpayer is same as the brokerage fees in the pure mortgage broker case and is fully taxable.

[27] Except those third party costs excluded per Det. No. 94-92, supra.

When the taxpayer acts as a lending broker, the Audit Division will evaluate the taxpayer's LOF reciepts to determine which qualify for the RCW 82.04.4292 deduction. To the extent the taxpayer and the Department agree, a test period may be agreed to and projections used for other periods. The test for qualifying fees is summarized as follows:

A. The taxpayer must be engaged in banking, loan, security, or other financial business;
B. The amount deducted was derived from interest received;
    1. There must be a legally enforceable obligation of the debtor to pay the creditor. Usury, statute of limitations, or other statute must not bar the payment.
    2. The debtor must have made the payment or the payment was made on behalf of the debtor. The gain from the sale of loans is not interest.
    3. The payment must not be for specific services such as a finder's fee, document preparation, title examination fees, notary fees, etc. To the extent that a fee charged to a borrower is for a combination of services and compensation for the use or forebearance of money, the fee will be allocated between service income and interest income.
C. The amount deducted was received because of a loan or investment. The taxpayer was the owner of a loan or investment. The owner of a loan or investment is the party who is entitled to receive the principal of the loan. Stated another way, the owner of the loan or investment is the person retains the risk of interest rate fluctuations
D. The loan or investment is primarily secured by a first mortgage or deed of trust; and
E. The first mortgage or deed of trust is on nontransient residential real property.

. . .

Further the following determinations are overruled or clarified to the extent specified here.

1. Det. No. 88-255, 6 WTD 123, is overruled to the extent it states the recognition of previously unrecognized LOFs are part of the receipts to determine the gain or loss on the sale of mortgages on the secondary market. Further, Det. No. 88-255 is limited in that it is not to be interpreted as allowing a deduction for 100% of LOFs.

2. Det. No. 90-141, 9 WTD 280-29, is overruled to the extent it holds the value of retained servicing rights upon the sale of a loan are part of the measure of the gain on sale of a loan. The retained servicing rights are taxable as received, but not as part of the measure of gain on sale.

3. Det. No. 89-452, 8 WTD 209, is overruled to the extent it treats the portion of the previously unrecognized LOFs entered on the seller's books and records as "service release premiums". The overruling of Det. No. 89-452 applies only when service release premiums are received upon sale of the loan. If the service release premium is paid to a former lender for the sale of the servicing rights, then the gross receipts are not deductible under RCW 82.04.4292 because the seller did not have the risk of interest rate fluctuation.

4. Det. No. 92-392, 12 WTD 535, is overruled to the extent it states the portion of the interest income stream retained by the seller of a qualifying mortgage continues to be deductible under RCW 82.04.4292 despite the seller's lack of risk of interest rate fluctuation.

Dated this 16th day of December, 1998.