Cite as 10 WTD 289 (1990)

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

In The Matter of the Petition For Correction of Assessment of	)	F I N A L
	)	D E T E R M I N A T I O N
	)	
	)	No. 89-259A
	)	
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .
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[1] RULE 163: RCW 82.04.320 -- RCW 48.14.080 -- B&O TAX -- PREMIUM TAX -- INSURANCE BUSINESS -- EXEMPTION. The exemption provided by RCW 82.04.320 supplies to insurance business only. The premium tax established by Chapter 48 is in lieu of all other taxes on insurance premiums, including taxes on income from insurance business activities.

[2] RULE 163: RCW 82.04.320 -- RCW 48.14.080 -- B&O TAX -- PREMIUM TAX -- INSURANCE BUSINESS -- EXEMPTION -- MORTGAGE LENDING. The preemptive language of RCW 48.14.080 applies for interest income derived from loans by insurance companies secured by mortgages on residential and commercial property. Insurance companies which internally perform mortgage lending activities in marshaling such loans are engaging in business activities which are functionally related to the insurance business.

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.

DEPARTMENT OF REVENUE REPRESENTED BY DIRECTOR'S DESIGNEES:
Steve Frisch, Deputy Director - Operations
Ed Faker, Assistant Director - Interpretation & Appeals

Anne Roys, Senior Administrative Law Judge

TAXPAYER REPRESENTED BY:

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DATE OF CONFERENCE: September 26, 1990

FACTS

Faker, Assistant Director -- This matter came for hearing before the Director's designees, Assistant Director Ed Faker and Administrative Law Judge Anne Roys on September 26, 1990. It arose on appeal from a letter ruling by the Department [in July of 1990] which supplemented Determination No. 89-259, issued [in May 1989]. That Determination related to a past audit period during which the taxpayer had been assessed Service B&O tax upon interest income derived from investments of diversified portfolio of income producing assets, including loans secured by mortgages on commercial and residential properties.

The facts related in Determination 89-259 are essentially correct and complete, except as noted herein. That Determination ruled in the taxpayer's favor for the past audit period based upon a finding that the taxpayer's income was derived directly from investments funded by insurance premiums. Such income is explicitly exempted from B&O taxation under RCW 48.14.080. The taxpayer, of course, does not appeal from that ruling.

The Department's [July 1990] letter informed the taxpayer that, based upon a Final Determination No. 88-311A, 9 WTD 293, issued subsequent to the taxpayer's Determination 89-259, the taxpayer should begin reporting B&O tax upon its interest income from mortgage lending activities effective on September 1, 1990. This decision resulted from an initial finding that the taxpayer was engaged in "independent entrepreneurial activities," separate and apart from the insurance business or the mere passive investment of insurance business income, to wit, the operating of a mortgage lending business. This letter indicated that the taxpayer, a licensed and regulated insurance company, was also engaged in the active and direct conduct of a trade or business resulting in the sales of services to parties unrelated to the insurance business. It concluded that the operation of a mortgage department, through

which funds are loaned on mortgage notes resulting in interest income, is subject to B&O tax.

The taxpayer petitioned the Director for review of the Department's letter position [August 1990], also requesting that the September 1, 1990 prospective tax liability date should be stayed, pending the Department's review and response. That request was granted.

TAXPAYER'S EXCEPTIONS

In its extensive petition, supported by the oral testimony of its investment staff and arguments at the September 26, 1990 hearing, the taxpayer sought to clarify what it perceives to be confusion and misunderstandings regarding the facts pertaining to its lending activities. It emphasizes the following, uncontroverted facts:

1. The taxpayer is a licensed insurance company, fully regulated under the Washington State Insurance Code, Title 48 RCW.

2. All of the taxpayer's investments, including its acquisition of debt obligations secured by mortgages are authorized and governed by chapter 48.13 of the Insurance Code.

3. The taxpayer does not put itself out to the public as a mortgage lending business in the financial marketplace.

4. The taxpayer does not itself market its pool of lendable funds; rather, its investments are arranged through independent mortgage bankers.

5. The taxpayer's loan transactions are closed through independent escrow companies.

6. The taxpayer does not actually perform the traditional functions of an independent mortgage lending company; it merely maintains a divisional staff which evaluates loan risks and marshals the taxpayer's pool of lendable income.

7. Generally, the independent mortgage bankers hired by the taxpayer service its loans (collect the interest, handle accounting, etc.).

8. Approximately 36% of its loans of insurance business income are serviced in-house, by the taxpayer's own employees, of which only 3% are loans to Washington State located borrowers.

9. The taxpayer has held properties foreclosed upon in collection of derelict loans, but it neither operates nor manages any such properties as distinct business undertakings.

Based upon these clarifications, the taxpayer asserts that it does no more or less in marshalling its insurance income assets than it is both authorized and mandated to do under the Insurance Code, specifically chapter 48.13 RCW. The taxpayer also provided extensive exhibits consisting of escrow agreement forms utilized by independent escrow-companies hired by the taxpayer and written servicing agreements with independent mortgage bankers which service the majority of the taxpayer's loan accounts.

The taxpayer admits that it engages in mortgage lending activities by making insurance business income available, as investments, in the financial marketplace. It insists, however, that the preemptory exclusion of RCW 48.14.080 and the B&O tax exemption of RCW 82.04.320 apply to interest income earned by an insurance company which engages in mortgage lending business. Moreover, the taxpayer expressly relies upon the ruling of the Department in Final Determination No. 88-311A, 9 WTD 293, in that the mortgage lending activity is "functionally related" to the taxpayer's insurance business.

DISCUSSION

As a matter of law, the Department is committed to the position that the conducting of business activities by an insurance company which have no functional relationship or fundamental connection with the business of selling insurance or preserving the financial assets of the insurance company are themselves, fully subject to the taxation provisions of the Revenue Act, Title 82 RCW. Simply put, the preemptive language of RCW 48.14.080 is not a plenary or carte blanche immunity such that a licensed insurance company may engage in any kind of income producing business activity it chooses without incurring business tax liability. See Final Determination No. 88-311A, 9 WTD 293.

However, we find that the activity of investing insurance premiums income and other insurance business related income through making loans secured by mortgages is "functionally related" to the insurance business. This activity is simply the methodology or financial mechanism through which an insurance company invests, as it is both authorized and required to do under the provisions of the Insurance Code.

There is little question that the State Legislature has acknowledged the fact that the marshalling and preserving of premiums and related insurance income is a fundamental and integrated part of the insurance business. Unquestionably the discreet commitment of its capital to produce a carefully calculated return has a direct bearing on all aspects of an insurance business, from premium rates to claim settlements. Moreover, this investment activity is not optional, it is mandatory. This is the very reason for the provisions of chapter 48.13 RCW. It is also the underpinning of our position in Final Determination 88-311A, 9 WTD 293.

The Insurance Code controls and regulates the business of domestic insurers. It provides, in pertinent parts, as follows:

> (1) No security or other investment shall be eligible for purchase or acquisition under this chapter unless it is interest bearing or interest accruing or dividend or income paying, is not then in default in any respect, and the insurer is entitled to receive for its exclusive account and benefit, the interest or income accruing thereon; except,
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> (a) that an insurer may acquire real property as provided in RCW 48.13.160, and
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> (b) that this section shall not prevent participation by an insurer in a mortgage loan if the insurer, either individually or jointly with other lenders, holds a senior participation in such mortgage or deed of trust giving it substantially the rights of a first mortgagee as to its interest in that loan.
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> RCW 48.13.020 (Emphasis ours).

Specifically,

An insurer may invest any of its funds in:

(1)(a) Bonds or evidences of debt which are secured by first mortgages or deeds of trust on improved unencumbered real property located in the United States;

(b) Chattel mortgages in connection therewith pursuant to RCW 48.13.150;

(c) The equity of the seller of any such property in the contract for a deed, covering the entire balance due on a bona fide sale of such property, in amount not to exceed ten thousand dollars or the amount permissible under RCW 48.13.030, whichever is greater, in any one such contract for deed.

(2) Purchase money mortgages or like securities received by it upon the sale or exchange of real property acquired pursuant to RCW 48.13.160 as amended in section 7 of this 1969 amendatory act.

(3) Bonds or notes secured by mortgage or trust deed guaranteed or insured by the Federal Housing Administration under the terms of an act of congress of the United States of June 27, 1934, entitled the "National Housing Act," as amended.

(4) Bonds or notes secured by mortgage or trust deed guaranteed or insured as to principal in whole or in part by the Administrator of Veterans' Affairs pursuant to the provisions of Title III of an act of congress of the United States of June 22, 1944, entitled the "Servicemen's Readjustment Act of 1944," as amended.

(5) Evidences of debt secured by first mortgages or deeds of trust upon leasehold estates, except agricultural leaseholds executed pursuant to RCW 79.01.096, running for a term of not less than fifteen years beyond the maturity of the loan as made or as extended, in improved real property, otherwise unencumbered, and if the mortgagee is entitled to be subrogated to all the rights under the leasehold.

> (6) Evidences of debt secured by first mortgages or deeds of trust upon agricultural leasehold estates executed pursuant to RCW 79.01.096, otherwise unencumbered, and if the mortgagee is entitled to be subrogated to all the rights under the leasehold.
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> RCW 48.13.260.

Moreover, RCW 48.13.220 provides that, after satisfying the requirements of RCW 48.13.260, above, an insurer may invest in any of numerous, specified businesses, including:

> (b) Investing, reinvesting, or trading in securities or acting as a securities broker or dealer for its own account, that of its parent, any subsidiary of its parent, or any affiliate or subsidiary;
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> . . .
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> (j) Any other business activity reasonably ancillary to an insurance business;
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> (k) Owning one or more subsidiary (i) insurers to the extent permitted by this chapter, or (ii) businesses specified in paragraphs (a) through (k) of this subsection inclusive, or (iii) other businesses the stock of which is eligible under RCW 48.13.240 or 48.13.250, or any combination of such insurers and businesses.

These regulatory statutory provisions, inter alia, clearly express the degree to which insurance companies are authorized and controlled in their pursuit of insurance business in this state. It follows, as an inescapable legal conclusion, that the preemptive provision of RCW 48.14.080, which limits taxation in this state upon insurance business, contemplates the very business activities referred to in the various sections of chapter 48.13 RCW set forth in parts above.

Also, our further review of the facts before us here, as now further clarified by the taxpayer, convinces us that the taxpayer does not exceed the authority vested in it under the Insurance Code in the operation of its insurance business. It does not independently conduct or operate a business as a mortgage lending institution. There is simply no evidence that the taxpayer acts as a mortgage broker or is licensed to do so, though, arguably, some of its employees perform services similar to those of a mortgage broker. In our view

these activities, including credit checks of potential borrowers, review of loan applications by its investments board, etc., are cumulatively no more than the Insurance Code and precedent insurance company practices dictate.

Accordingly, we find that the taxpayer's mortgage lending is a functionally related and integral part of its business as an insurance company. The interest income derived therefrom is excluded from B&O taxation under RCW 48.14.080 and our Final Determination No. 88-311A, 9 WTD 293. The Department's letter of [July 1990] advising the taxpayer to begin reporting interest income effective September 1, 1990 is hereby rescinded, ab initio.

A cautionary note is appropriate. The department has long held that the outright making of loans to derive interest income constitutes engaging in a taxable business activity. Thus, this activity is not entitled to the business tax exemption of RCW 82.04.4281 for amounts derived by businesses other than financial businesses from investments or the use of money as such. We do not recant from that position here. Rather, we rule that the financial business of making loans, when done by a licensed and regulated insurance business, is expressly excluded from the B&O tax of Title 82 RCW because of the provisions of RCW 48.14.080. Furthermore, it is immaterial that the insurance business makes such loans through its own mortgage lending division, as a mortgage broker, or otherwise.

Finally, the taxpayer has raised several issues relating to the prospectivity of any ruling that its interest income from mortgage loans would be taxable as well as its entitlement to apportion such income based upon the out-of-state locations of the servicing of such loans. Obviously, because of our ruling on the exemption issue, we need not reach these corollaries. We also are not required or requested to rule upon the question whether any of the taxpayer's income from set-up fees, loan origination fees, or non-interest service charges would be taxable if the taxpayer fully engaged in business as a distinct mortgage lending entity in competition with others in the financial marketplace. We expressly withhold such rulings.

DECISION AND DISPOSITION

The taxpayer's petition is sustained.

Dated this 30th day of November, 1990.