BEFORE THE BOARD OF TAX APPEALS
STATE OF WASHINGTON

FACTORY MUTUAL ENGINEERING ASSOCIATION, Appellant, v. STATE OF WASHINGTON DEPARTMENT OF REVENUE, Respondent.	)	Docket No. 36836 Re: Excise Tax Appeal FINAL DECISION

EXEMPTION STATUS AND EXCISE TAX IN CONTROVERSY FOR 1979-1986

TAX YEAR	DEPARTMENT OF REVENUE DETERMINATION	BOARD OF TAX APPEALS DETERMINATION
1979	$ 7,900.00	$ 7,900.00
1980	$ 8,600.00	$ 8,600.00
1981	$ 9,319.14	$ 9,319.14
1982	$ 10,528.46	$ 10,528.46
1983	$ 16,836.61	$ 16,836.61
1984	$ 15,715.01	$ 15,715.01
1985	$ 16,846.85	$ 16,846.85
1986	$ 21,024.84	$ 21,024.84

This matter came before the Board of Tax Appeals (Board) for an informal hearing on November 16, 1989, to review the determination by the Department of Revenue of excise tax applicability for the taxpayer's property for the tax years 1979 through 1986. Donald J. Ekman, Loren D. Prescott, and W. Jay Swiatek, Attorneys, represented Appellant, Factory Mutual Engineering Association (Factory Mutual). Also testifying for Factory Mutual were J. J. Galvin and R. A. Harkins. Patricia Johnson, Attorney, Interpretation and Appeals Division, represented Respondent, Department of Revenue (Department).

FINDINGS

Factory Mutual is an association owned by three insurance companies (Parent Companies).[1] The Parent Companies underwrite property insurance for commercial properties. Factory Mutual provides information to the Parent Companies, which each use to evaluate the property risks that they insure. Factory Mutual and its Parent Companies comprise the organization known as the Factory Mutual System (System).

Factory Mutual resulted from a pooling arrangement concept that was established to provide uniform quality services in an economic and efficient manner. This arrangement was prompted by the considerable amount of detailed, credible information the Parent Companies required in order to properly underwrite their property insurance. Because of the size and highly specialized nature of the risks insured, each individual company would pay a higher cost if it attempted to obtain the information through its own resources.

A Board of Directors, separate from, but composed of, officers of the Parent Companies governs Factory Mutual. Factory Mutual accounts for its employees for federal tax purposes and retirement benefits separately from those of the Parent Companies. Factory Mutual employees execute inspections including engineering, loss prevention inspections, and loss claim adjustments, and make recommendations to the Parent Companies for insurance underwriting purposes.

The services that Factory Mutual renders are done exclusively for its Parent Companies and are not available to any company outside of the System. Factory Mutual has a local district office in Bellevue, Washington.

The Parent Companies compensate Factory Mutual for services rendered on a cost basis. Each Parent Company is required to pay the costs associated with its requests for specific services. These costs include reimbursement to Factory Mutual when it issues a check for loss or other compensation to an insured on behalf of the Parent Companies.

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[1]F Factory Mutual was originally formed in January 1976 by four parent insurance companies: Allendale Mutual Insurance Company, Arkwright-Boston Manufacturers Mutual Insurance Company, Philadelphia Manufacturers Mutual Insurance Company, and Protection Mutual Insurance Company. Philadelphia Manufacturers Mutual as a separate entity is no longer a party to the agreement.

Factory Mutual relies directly and totally upon the Parent Companies for financial support. Under its financial structure, chosen by the Parent Companies, Factory Mutual owns few assets other than sufficient capital to cover operating costs. Therefore, the Parent Companies periodically act as guarantors for Factory Mutual on leasing and other contract arrangements. Because of this financial structure, Factory Mutual does not incur federal income tax liability.

Factory Mutual as a separate entity does not engage in the business of insurance: the transference of a policyholder's risk for which the insurer receives payment in the form of premium dollars.

In July 1986, the Department informed Factory Mutual that its activities may have constituted "engaging in business" as defined by RCW 82.04.140 and RCW 82.04.150. Subsequently, the Department found (Determination No. 88-206, May 3, 1988) that Factory Mutual's income was subject to business and occupation (B&O) tax. The Department based its decision on its belief that Factory Mutual was not a qualifying insurance company registered under Chapter 48.14 RCW; its income was not received from insurance premiums or taxable under RCW 48.14.080; and it was engaged in business as a service provider to its Parent Companies, not engaged in the business of insurance itself. Final Determination No. 88-206A (April 25, 1989) sustained the previous Determination No. 88-206.

The issue before us is whether Factory Mutual is an organization integral to its Parent Companies (a department or division) thereby enjoying the benefits afforded by RCW Title 48 or a separate entity liable for the B&O taxes identified in RCW Title 82. And, if it is identified as the latter, can its activities be defined within the meaning of "insurance business" and therefore allow it to meet the requirements of Chapter 48.14 RCW.

Contentions of the Parties:

Factory Mutual maintains that the statute exempting gross income derived from the insurance business from the B&O tax (RCW 82.04.320) is applicable to its income because it is not a company but a division or department of its Parent Companies. The Department argues that Factory Mutual is a separate entity and, as such, its services do not constitute "insurance business". The services and activities of Factory Mutual constitute "engaging in business" as defined by RCW 82.04.140 and RCW 82.04.150. Therefore, the crux of the matter is the nature of Factory Mutual as an organization.

Factory Mutual contends that although the name had changed earlier, it has performed the same work it always had. For all practical purposes, it operates as a division of each of the Parent Companies. When viewed as an integral part of the entire System, Factory Mutual is, in fact, in the insurance business. Factory Mutual states unequivocally that without it providing those services, the three System insurance companies would be unable to issue or service their policies of insurance. The Parent Companies' decisions of whether to insure a certain location and at what insurance rates -- decisions key to the insurance business -- are based on the evaluations and recommendations of the Factory Mutual Loss Prevention consultants. If a loss occurs, Factory Mutual investigates the loss and determines whether there is policy coverage for that particular loss. It also determines the cause, the circumstances, and the scope of the loss, and makes recommendations to prevent reoccurrence. Factory Mutual determines the size of the loss and then pays in accordance with the policy in force.

To emphasize the integral nature of the organization, Factory Mutual notes that the Parent Companies pay all the expenses, bear all the risks, and are directly responsible for any loss experienced by Factory Mutual. Factory Mutual makes no profit and depends on support from its Parent Companies for its budget. Additionally, the Parent Companies shoulder any expenses assessed against Factory Mutual, including taxes. Between the years 1985 to 1988, the Parent Companies paid over $2,000,000 in gross premium taxes to the State of Washington under RCW Title 48. Also, the chief executive officers of the Parent Companies make all management decisions that affect Factory Mutual, including the budget, administrative procedures, and operations.

To support its assertion that its services are in fact at the center of the insurer/insured relationship, Factory Mutual references supporting cases including the case of Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 99 S.Ct. 1067, 59 L.Ed. 2d 261 (1979), in which the U.S. Supreme Court set forth three tests to determine if a practice is a part of the "business of insurance". This three-part test requires a determination of: (1) whether the practice has the effect of transferring or spreading a policy's risk, (2) whether the practice is an integral part of the policy relationship between the insurer and the insured, and (3) whether the practice is limited to entities within the insurance industry. Factory Mutual asserts that the System of which it is an integral part passes the test. In so passing the test, Factory Mutual, as a part of the

overall System organization, qualifies for exemption from the B&O tax pursuant to RCW 82.04.320. The premium tax established by RCW Title 48 is exclusive and in lieu of all the taxes on insurance business. The Parent Companies are responsible for a gross premium tax which is in lieu of the B&O tax.

Factory Mutual is listed as a partnership with the federal government. However, that identification was forced upon them by the structure of the federal form. In substance, it is not a partnership and has never been a partnership. There is no indication in the Services Agreement signed by the parties that this relationship formed a partnership or that even the word partnership was used. Moreover, the System does not meet the test of a partnership under the laws of the state of Massachusetts, the state whose law governs the agreement.[2]

The Department apparently has no argument in defining an organization that is in "the business of insurance". It does not argue against the Supreme Court test. It does not deny that the Parent Companies are insurance companies whose insurance activities fall within RCW Title 48. Its main contention is that Factory Mutual is not an integral part of the Parent Companies, much like a division, but is rather a separate entity whose business supports insurance companies. In the Department's view, Factory Mutual engaged in business as defined by RCW 82.04.140 and RCW 82.04.150. Consequently, its income is subject to B&O tax.

The Department argues that Factory Mutual, as an organization, is not engaged in the business of insurance. The Department defines the insurance business to be the "transference of a policyholder's risk for which the insurer receives payment in the form of premium dollars". Factory Mutual does not pay tax in Washington on gross premium dollars because it receives none for its activities. The Department stresses that Factory Mutual fails to show that the entity itself is engaged in the business or, for that matter, is even a department of an insurance company. The Department claims that the Services Agreement is in fact a contract structured as a partnership agreement. It creates an entity separate from the Parent Companies and then grants that entity authority to act in their behalf when rendering

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[2] Paragraph 6.5 of the Services Agreement states, "This Agreement shall be deemed to be a contract made under, and shall be construed in accordance with the laws of the Commonwealth of Massachusetts."

services for them. However, that entity is not empowered to transact insurance or to compete with its Parent Companies. Therefore, Factory Mutual is not an insurer as defined by RCW 48.05.040. It is not a stock, mutual, or reciprocal insurer; does not have capital funds as required by the statute; does not transact, propose to transact insurance; and it does not fully comply with or qualify according to the other provisions of the insurance code. Therefore, as it is not an insurer, it does not qualify for the exemption from other taxes granted to qualifying insurers under RCW 48.14.080. Factory Mutual renders services to its Parent Companies enabling them to reduce costs associated with their insuring activities. But it is not an insurance company itself, and is subject to B&O tax under RCW 82.04.290.

ANALYSIS AND CONCLUSIONS

Factory Mutual and the Department were each given full opportunity to place their arguments before the Board. The Board, having considered all the testimony and documentary evidence submitted by the parties in support of their respective positions, hereby enters the following analysis and conclusions:

Under WAC 458-16-100(5), the burden rests upon the one claiming exemption to show clearly that the property is within the exempting statute.

The burden of showing qualification for the tax exemption rests with the taxpayer. Catholic Archbishop v. Johnston, 89 Wn.2d 505, 507, 573 P.2d 793 (1978); Student Housing v. Department of Revenue, 41 Wn. App. 583, 705 P.2d 793 (1985).

Taxation is the rule and exemption is the exception. Department of Revenue v. Schaake Packing Co., 100 Wn.2d 79, 84, 666 P.2d 367 (1983); Student Housing v. Department of Revenue, 41 Wn. App. 583, 705 P.2d 793 (1985).

The ultimate issue is whether Factory Mutual is a separate legal entity from its Parent Companies. Resolution of this issue requires an examination of four characteristics of an organization: (1) organizational structure; (2) status of employees; (3) ownership of property; and (4) liability for expenses, profits, and losses.

The evidence shows that Factory Mutual has a "mixed bag" of characteristics. Some point to the conclusion that it is an integral or organizational part of its Parent Companies,

while others point to the conclusion that it is a separate organization with its own legal identity.

Organizational Structure. Factory Mutual's management structure is separate from the Parent Companies. It is governed by a Board of Managers consisting of the president of Factory Mutual and the chief executive officers of the Parent Companies. In the event of a dispute between the Parent Companies and Factory Mutual, the matter is to be resolved by an independent arbitrator and resort to the courts, rather than being resolved by a common superior. The organization is not a partnership under Massachusetts law, but that does not mean that it is a part of the Parent Companies. It is more in the nature of a joint venture operating as an unincorporated association. Such organizations are, or could be, considered "persons" for purposes of Washington's B&O tax. RCW 82.04.030. Had the Parent Companies provided this service within their own organizations, the cost would have been expensed from their gross premium income. The System chose to form an association to perform this function.

Employees. Factory Mutual apparently hires, trains, fires, compensates, and otherwise directs and controls the activities of its employees. At least there is no claim or evidence that any of the Parent Companies do so. Factory Mutual considers itself to be the employer for purposes of federal income tax withholding and Social Security purposes. It maintains a separate retirement system for its personnel. On the other hand, the agreement with the Parent Companies states that the employees of Factory Mutual are to be considered the employees of each of the Parent Companies when rendering services to the Parent Companies. Presumably, this would be most of the time, since Factory Mutual does not work for any other companies. However, this is apparently not the case when personnel are in training, on vacation, or out sick; nor in the case of administrative or support personnel who do not necessarily work on specific projects of identified Parent Companies. Here, the personnel are under the total control of Factory Mutual.

Property. Factory Mutual does not take title to real property in its own name. Title to real property used by Factory Mutual (primarily its training center in Massachusetts) is in the name of a separate organization. Factory Mutual leases its facilities in Washington. The evidence is not clear whether Factory Mutual leases facilities and equipment in its own name, or whether the separate corporation is the named lessor. The agreement creating Factory Mutual does, however, contemplate that Factory Mutual

might acquire and hold tangible assets. (Services Agreement, at 2.) At the present time, Factory Mutual has no significant assets.

Expenses, Profits, and Losses. Between Factory Mutual and its Parent Companies, Factory Mutual, as a general rule, is not ultimately liable for expenses and losses. It is reimbursed for its expenses under a pre-arranged formula by the Parent Companies. It actually pays for its own expenses, such as employee salaries and benefits. Any losses are the ultimate responsibility of the Parent Companies. In this connection, it is noteworthy that Factory Mutual can and does settle claims on behalf of the Parent Companies, and pays claims on their behalf to persons insured by them.

On balance, Factory Mutual has more characteristics of a separate organization than one which is an integral part of the Parent Companies. The Board has a difficult time giving weight to the plea that the Parent Companies cannot function without the services of Factory Mutual. Though it may be true, it is also irrelevant. The insurance companies in Armstrong v. State of Washington, 61 Wn.2d 116, 377 P.2d 409 (1962) could not get along without the agent's services, either. Also, testimony suggests that the services of Factory Mutual could be performed by an outside contractor. Therefore, the Parent Companies can function without the services of Factory Mutual. Again what matters most is the separate character of the organization providing services to the Parent Companies. We also give little weight to the fact that these Parent Companies were all one family at one time. The System chose this organizational form for good business reasons; therefore, it should be treated as it is by the tax laws of the state.

Consequently, as a separate entity Factory Mutual cannot be considered an insurer (or in the business of insurance) and therefore exempt from B&O tax under the "in lieu" provisions of RCW 48.14.080. It is not an insurer; i.e., Factory Mutual is not a person engaged in the business of making contracts of insurance. RCW 48.01.050.

Ultimately, we find Factory Mutual to be an organization run largely on the reimbursement method of doing business. The B&O tax system, being a transaction based tax, taxes all gross income resulting from transactions in which money or its equivalent changes hands. There is no denying that money is being transferred. It is more than the Parent Companies taking it out of one pocket and putting it into another; they

are taking it out of their pocket and putting it into Factory Mutual's pocket.

The Department's rules do allow for deductions from gross income for advances and reimbursements. See WAC 458-20-111. During the hearing, Factory Mutual testified that it paid claims on behalf of its Parent Companies. Apparently unaware of WAC 458-20-111, Factory Mutual did not make an argument that reimbursement for these payments should be deductible from the B&O tax. The Department was unsure whether these payments might qualify for deduction from the measure of the B&O tax as advances or reimbursements. Given the possibility that some of these payments might be deductible, in the interests of justice the Board remands this matter to the Department for its initial consideration as to whether any payments received from Factory Mutual's Parent Companies may be treated as reimbursements under WAC 458-20-111.

DECISION

Determination No. 88-206A (Registration No. C600 636 861), issued on April 25, 1989, by the State of Washington Department of Revenue, is sustained. The appeal is remanded to the Department for a determination as discussed above.

The Department of Revenue is hereby directed to abide by and give full effect to the provisions of this decision.

DATED this _____ day of _____, 1990.

BOARD OF TAX APPEALS

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LUCILLE CARLSON, Chair

See Dissenting Opinion
RICHARD A. VIRANT, Vice Chair

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MATTHEW J. COYLE, Member

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A timely Petition for Reconsideration may be filed to this Final Decision within ten days pursuant to WAC 456-10-755, a copy of which was provided to you earlier either on form BTA300, Your Right To An Appeal, or form BTA305, Answering The Assessor's Notice Of Appeal.

Dissenting Opinion:

I find the structure of the System to be a unique, but logical structure (because of the type of insurance activities with which it is involved). I readily accept the court cases referenced by the Department; however, I believe these references miss the mark. I concur with the findings of Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205 (1979) that the relationship between the insurance company and the pharmacies was not related to the business of insurance but rather an agreement to effect a cost saving. Nor do I have a quarrel with the findings in Union Labor Life Ins. Co. v. PIRENO, 458 U.S. 119 (1982). Here, the function of the Peer Review Committee was narrow in scope and self-serving. Its services, which aided insurers in evaluating claims, do not compare with Factory Mutual's services either in scope or depth. A parallel is found in Hahn v. Oregon Physicians Service, 689 F.2d 840 (1982). Again, the organization was outside the primary function of the insurance company and, unlike Factory Mutual, was not designed to define the peril, but was merely a cost-cutting device for the insurers.

I also agree that the services of an independent agent as noted in Armstrong v. State of Washington, 61 Wn.2d 116, 377 P.2d 409 (1962) may be in the insurance business, but not in the business of insurance. However, I believe that Armstrong is key in this case. I quote, at 120:

> As indicated heretofore, a tax is imposed on all insurance companies, measured by the gross premiums received from business in Washington; RCW 48.14.020. This gross premium tax has been labeled an "in lieu of" tax by RCW 48.14.080. RCW 82.04.320 . . . specifically provides that RCW 82.04 (B and O tax) does not apply to any person in respect to insurance business upon which the gross premium tax has been imposed. But the exemption does not apply to those who engage in the business of representing insurance companies.
> Although the appellant performs the same functions for insurance companies as do their branch offices, there is a substantial difference. The crux of the matter is that the appellant operates his own

> separate business, which performs services for the insurance companies; whereas the branch offices are an integral or organizational part of the insurance companies.

(Underscore added.)

Insurance companies may exist without independent agents. They may exist as some do, without agents at all; using a direct mailing approach. Analogous to the body, the agents are fingers which allow the entire system to function more smoothly but are not required for its existence. As described in testimony, the function of Factory Mutual is more like the internal workings of the body without whose existence there would be no life. It existed solely for and at the pleasure of the Parent Companies. Unlike the insurance agents, Factory Mutual is not its own separate business. Yet, without Factory Mutual providing its services, its Parent Companies would be unable to issue or service their policies. No insurance company would issue a policy without first determining the risk involved or its level. Nor do I disagree with the argument that the services provided by Factory Mutual could be performed by an outside contractor. But then again, each and every operation, function, or responsibility of any organization or corporation can be contracted, so the argument is moot.

Black's Law Dictionary[3] defines insurance as: "A contract whereby, for a stipulated consideration, one party undertakes to compensate the other for loss on a specified subject by specified perils." In order to determine the level of the premium charged, an insurance company must know what the risk is, for it is in the business of covering a risk. Factory Mutual, as an integral part of the System provides input on which its Parent Companies can assess that risk. Whether the Parent Companies maintain that function within their own organizations and call them divisions, or share that function for the purposes of economies of scale, those services are integral and the basis for their operation.

I agree, as the Department contends, that it is true Factory Mutual, if viewed as a separate entity, does not meet the test designed to identify an insurance company. I do not believe that monies used to support the services of Factory

[3] Black's Law Dictionary 721 (5th ed. 1979).

Mutual can be regarded as insurance premiums subject to the premium tax. This supports the finding that Factory Mutual as an entity is not in the business of insurance. However, I believe the point to be of little concern, for I find Factory Mutual to be as stated in Armstrong: "an integral or organizational part of the insurance companies".

I find no fault with the Department's reasoning that the premium tax is only in lieu of the B&O tax on insurance premiums, and not in lieu of tax on any business engaged in by an insurance company other than its insurance business. However, as noted, I find the function of Factory Mutual being integral to the Parent Companies is insurance business.[4]

Having determined that Factory Mutual is no more or no less than being analogous to a division, the rest falls into place. Also, the arguments whether Factory Mutual as a separate entity is exempt from B&O taxes need not be addressed. Therefore, from these conclusions, I believe the correct decision to be that Determination No. 88-206A (Registration No. C600 636 861), issued on April 25, 1989, by the State of Washington Department of Revenue, should be reversed.

RICHARD A. VIRANT, Vice Chair

[4] Having determined the character of Factory Mutual, I find that RCW 82.04.240, as interpreted by RCWA 82.04.240, Notes of Decisions, Note 7, at 90, is not applicable. The tax liability of Factory Mutual is within the purview of its Parent Companies.