Cite as Det. No. 92-393, 12 WTD 253 (1993).

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

In The Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 92-393
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .
and	)	
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] RCW 82.04.080, RULE 111: B&O TAX -- GROSS INCOME OF THE BUSINESS -- EXCLUSION FROM MEASURE OF TAX. Where taxpayer provided evidence demonstrating that it was not liable for third-party services and that creditors looked solely to the escrow accounts for payment or would refuse entirely to perform the service, the funds deposited in escrow accounts were excluded from the measure of the taxpayer's tax base.

[2] RCW 82.12.020: USE TAX -- LIABILITY FOR PAYMENT. The fact that the taxpayer was not actually making its scheduled lease payments does not relieve the taxpayer from the corresponding tax liability in relation to the leased property.

[3] RCW 82.12.0252: USE TAX -- EXEMPTION. The exemption is only applicable to situations where a sale or use has previously been taxed. No exemption is granted in the statute to cover the case of a lessee who is no longer making payments on the lease.

[4] RCW 82.12.020, RULE 155, RCW 82.12.010: USE TAX -- LICENSING FEE FOR SOFTWARE -- VALUE OF ARTICLE USED. The use of standard, pre-written software is subject to the use tax if the retail sales tax has not been paid for the software. The value of the software is readily determined by the amount of the lease paid for its use.

TAXPAYERS REPRESENTED BY: . . .

DATE OF TELECONFERENCE: . . .

NATURE OF ACTION:

Taxpayers, hereinafter referred to as "Broker" and "Escrow," protest the assessment of taxes on income from their mortgage business activity.

FACTS AND ISSUES:

Hesselholt, Chief A.L.J. -- Taxpayers conduct business as both a mortgage broker (Broker) and as an escrow agent (Escrow). In neither capacity do they lend money directly but, rather, they arrange loans through other lenders. They maintain trust accounts where customer funds are deposited to pay expenses that the customers have agreed to pay. Because these businesses have common ownership and do business in close proximity to each other and because the issues are related, decisions for both will be rendered in this determination.

The books and records of Broker and Escrow were examined by the Department of Revenue, and assessments were issued. Broker protests assessment of tax on: (1) unreported service income for fees paid to third-party vendors and (2) use tax on leased equipment and software. Taxpayers additionally protest the assessment against Escrow of use tax on a computer lease purchased by Escrow, for which lease payments are not currently being received from its affiliate, Broker.

Broker functions as both a Mortgage Banker and Mortgage Broker. Escrow functions as an Escrow Agent. As such, and depending on the type of loan involved, Broker is subject to the regulations of the Housing & Urban Development Agency ("HUD"), the Federal National Mortgage Association ("Fannie Mae"), and the Federal Home Loan Mortgage Corporation ("FHLMC") as well as the provisions of the Mortgage Broker Practices Act and the Real Estate Settlement Procedures Act ("RESPA"). Escrow Agents are regulated by chapter 18.44 RCW.

A typical transaction involving Broker begins with a client seeking a loan. This client normally has already found the property for which a loan is sought. Broker takes a loan application and obtains a security deposit to cover the costs of a credit report and title insurance. The security deposit is placed into an escrow account and the loan application is processed.

Earnest Money Agreements signed by sellers and borrowers authorize the agent to order all items necessary for the closing

of the transaction and agree to the payment of the costs prior to their order. A statement accounts specifically for all funds and reflects the funds on deposit as belonging to either the borrower or the seller. The funds never belong to the Mortgage Broker or Escrow Agent. All third-party vendors look ultimately for payment of their services to the funds deposited by parties to the transaction in the escrow account. Any funds from escrow required to process the application (such as paying the title insurance company for its report on the property) are disbursed as required. At the close of the sale, any funds remaining in the escrow account are returned to whoever originally placed them there. Among the fees paid from the escrow account is a 1% service fee, which is charged by Broker for its services.

Broker does not retain any of the mortgages/deeds of trusts that it assists customers in obtaining and does not any longer service the loans, although it has done so in the past. Both taxpayers provide the customer an estimate of the fees and charges arranged and require payment of the fees in advance. The fees are deposited in a separate escrow trust account.

After the hearing, Broker provided a statement from a title insurance company that it did not consider Broker liable for its fees. In the event a transaction is cancelled, the title insurance company said that it would not pursue Broker for its fees. A statement was also provided from the appraisal firm that did most of the appraisal work for Broker's customers. This statement indicated that the company mandates the prepayment of the report to minimize pressures on the appraiser. The prepayment is placed into an escrow account. If the funds were to be mismanaged, this service would place a mechanic's lien on the property to ensure it received payment for the appraisal. It would look not to Broker but rather to the escrow account established for the payment of appraisal fees. An additional statement was provided from a mortgage credit provider, which stated that Broker acted as the company's agent in collecting and forwarding money for services from prospective borrowers.

Broker entered into a lease with Leasing on January 25, 1989, for the lease of computer equipment provided by Fannie Mae. The copy of the lease shows no sales tax paid. Escrow purchased the lease from Leasing on May 5, 1989. When Broker ceased making lease payments, it also ceased its use tax payments. Escrow did not pay use tax after Broker ceased its lease payments. Broker also entered into a lease of computer software with Fannie Mae for which it paid certain license fees. No use tax was paid on the software.

The Department contends that (1) the funds paid by the borrowers to the trust account were taxable income to Broker; (2) Broker

owes use tax on the lease of the computer equipment regardless of whether it is currently making lease payments; (3) if Broker does not pay use tax on the computer equipment, alternatively, Escrow owes use tax on the computer equipment regardless of whether it is currently receiving lease payments; and (4) use tax is owed for the use of leased computer software by Broker.

Taxpayer asserts that: (1) The funds paid by the borrowers to Broker and placed in the escrow trust account should not be included in its measure of tax base under WAC 458-20-111 because it was not liable for the expenses paid with these funds; (2) Broker should not be liable for use tax on the computer lease until it resumes its lease payments; (3) Escrow should not be liable for use tax until lease payments are resumed but should not be liable at all if Broker makes use tax payments; and (4) Broker should not be liable for use tax on the licensing fees paid to Fannie Mae for the computer software.

DISCUSSION:

I. Should the tax on unreported service income exclude assessments on amounts placed in a separate escrow account and then paid by Broker to third-party vendors?

RCW 82.04.220 imposes business and occupation tax on the gross income of a business. RCW 82.04.080 defines "gross income of the business" as the value proceeding or accruing by reason of the transaction of the business engaged in. WAC 458-20-111 (Rule 111) excludes advances and reimbursements from income. Rule 111 applies only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no liability for the payment, other than as agent for the customer or client.

The Mortgage Broker Practices Act addresses in RCW 19.146.050 requirements in this State for the handling of escrow accounts by brokers:

> A mortgage broker shall deposit, prior to the end of the next business day, all moneys received from borrowers for third-party provider services in a trust account of a federally insured financial institution located in this state. The trust account shall be designated and maintained for the benefit of borrowers. Moneys maintained in the trust account shall be exempt from execution, attachment or garnishment. A mortgage broker shall not in any way encumber the corpus of the trust account or commingle any other operating funds with trust account funds. Withdrawals from the trust account shall be only 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 borrowers at closing.

RCW 19.146.030 (2) specifically identifies the types of third-party provider services covered by the Mortgage Broker Practices Act:

> The itemized costs of any credit report, appraisal, title report, title insurance policy, mortgage insurance. escrow fee, property tax, insurance, structural or pest inspection, and any other third-party provider's costs associated with the residential mortgage loan. Disclosure through good faith estimates of settlement services and special information booklets in compliance with the requirements of the Real Estate Settlement Procedures Act, 12 U.S.C. Sec 2601, and Regulation X, 24 C.F.R. Sec. 3500, as now or hereafter amended, shall be deemed to comply with the disclosure requirements of this subsection ...

However, RCW 19.146.020 specifically exempts certain parties from the provisions of the Mortgage Broker Practices Act:

> (1) Any person doing business under the laws of this state or the United States relating to banks ...
> (6) Any mortgage broker approved and subject to auditing by the federal national mortgage association, the government national mortgage association, or the federal home loan mortgage corporation;
> (7) Any mortgage broker approved by the United States secretary of housing and urban development for participation in any mortgage insurance program under the National Housing Act, 12 U.S.C. Sec. 1701, as now or hereafter amended ...

This would exempt from regulation by the Mortgage Broker Practices Act any of Broker's transactions dealing with the federal programs it cites. Those transactions would be covered by federal regulations.

Section 2602(3) of the Federal Real Estate Settlement Practices Act, 12 U.S.C. §§ 2601-2614, defines "settlement services" as:

> "any service provided in connection with a real estate settlement including, but not limited to, the following: title searches, title examinations, the provision of title certificates, title insurance,

> services rendered by an attorney, the preparation of documents, property surveys, the rendering of credit reports or appraisals, pest and fungus inspections, services rendered by a real estate agent or broker, and the handling of the processing, and closing or settlement."

RCW 18.44.070 provides that an escrow fund account be kept "separate and apart and segregated from the agent's own funds." The statute prohibits the escrow agent from disbursing funds from the account unless there has been a deposit directly relating to the account which was equal to or greater than the disbursement.

WAC 308-128E-011 is the Department of Licensing's regulation governing the administration of funds in escrow accounts. It prohibits the escrow agent from using such funds for the benefit of the agent. Subsection (8) provides that the reconciled trust account(s) must equal at all times the outstanding trust liability to clients. Subsection (14)(a) prohibits the use of the account for items not pertaining to a specific escrow transaction or escrow collection account. Subsection (14)(d) prohibits disbursements from the account:

> In payment of a fee owed to any employee of an agent or in payment of any business expense of the agent. Payment of fees to employees of an agent or of any business expense of the agent shall be paid from the regular business account of the agent;

Although there is no federal provision which specifically prohibits an escrow agent or mortgage broker from misusing funds in an escrow account, 12 U.S.C. § 2607 (b) does state:

> No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan <u>other than for services actually performed</u>.

(Emphasis supplied.)

12 U.S.C. § 2607(d)(6) states that "no provision of State law or regulation that imposes more stringent limitations on controlled business arrangements shall be construed as being inconsistent with this section."

Broker argues that the tax on Unreported Service Income was wrongfully assessed on amounts paid by Broker to third-party vendors. These amounts were never actually received by Broker as

such, but were placed in a separate escrow account by Broker for third-party settlement services for borrowers using Broker as their mortgage broker.

Broker states that it is not liable other than as an agent for the fees incurred on behalf of its customers. This was corroborated by letters it provided from three of the third-party service providers:

> (1) A title insurance company stated that title insurance is not issued unless the premium is collected at the time the order is placed.
>
> (2) An appraisal service stated that the company mandates the report's prepayment, which is placed into an escrow account by Broker. If the funds in the escrow account were to be mismanaged, the appraisal service would place a mechanic's lien on the property to ensure it received payment for its work. It would not look to taxpayer, but rather to the escrow account established for the payment of appraisal fees.
>
> (3) A mortgage credit report provider stated that Broker acted as its agent when it collected and forwarded money for credit reports to the credit report provider.

All letters state that the normal procedure is for the payments to be made from the escrow account where the funds for these services have been deposited.

Rule 111 defines an "advance" as "money or credits received by a taxpayer from a customer or client with which the taxpayer is to pay costs or fees for the customer or client." According to the rule, an "advance" can occur only when the customer or client alone is liable for payment of the fees or costs and when the taxpayer making the payment has no personal liability other than as an agent for the customer or client. It states where such an advance occurs:

> There may be excluded from the measure of tax amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession.

Most of the unreported income in question constituted advances from Broker's customers to an escrow account. The customer would give the advance to Broker, who would then deposit the advance in an escrow account and order title insurance, credit reports, and an appraisal. Fees for those services would be paid by Broker

from the escrow account. Broker was also certified as an escrow agent and was required to keep a separate escrow fund account under RCW 18.44.070.

Broker used the account only to hold other peoples' money forwarded to it. After completing a transaction, the taxpayer received its fee from the escrow account by writing a check to itself pursuant to the escrow agreement and instructions. See WAC 308-128E-011(12)(a).

The Department argues that previous Determinations relating to similar expenses by banks for mortgages control in this case. A similar argument was made in Det. No. 92-073, 12 WTD ___ (1993), where the Department determined it necessary to distinguish from prior Department Determinations (Det. No. 89-461, 11 WTD 21 (1989) and Det. No. 90-95, 9 WTD 189 (1990)) for charges by banks for similar expenses related to mortgages:

> In those determinations, the banks were found to be liable for the third-party expenses. Other than bare assertions, no evidence had been provided to establish that the banks were acting as agents. There is no indication that escrow accounts subject to the limitations of RCW 18.44.070 were used.

In this case, the taxpayer has provided third-party evidence that it was not liable for the third-party services. The creditors looked to the escrow accounts for payment or simply refused to perform the service required. The creditors did not look to Broker for payment. As an escrow agent, the taxpayer was legally prohibited from using the escrow account for its own business expenses. We agree with Broker and find that funds deposited in the escrow account by it for payment of third-party services are not the taxpayer's receipts and should not be included in the measure of its tax base.

Broker also argues that in all its real estate transactions, whether state or federal, it considered itself bound by Washington state regulations as set out in the Mortgage Broker Practices Act and that all transactions should receive the same tax treatment. The Department contends that the federal real estate transactions were specifically exempted from state regulation by the statute.

Although any federal loan transactions made by Broker were explicitly exempted from the state regulations set out in the Mortgage Broker Practices Act, in this instance, Broker has voluntarily submitted itself to those more stringent regulations. The controlling federal regulation, the Real Estate Settlement Practices Act, appears to allow the State to control the

transactions if it chooses to do so. We agree with Broker that, having submitted itself to the more stringent regulations of the State for these federal loan transactions, it is entitled to the same tax treatment for them as for the transactions wholly controlled by the State law.

II. Does Broker owe use tax for its use of computers and software leased originally from Leasing even though it is not currently making lease payments on such equipment and software to the new owner of the lease, Escrow?

The Department's Audit Division has assessed use tax on the use of the computer equipment leased by Broker, first from Leasing and subsequently from Escrow. Broker asserts that it is not liable for the use tax because it is not currently making payments on its lease and that the tax is not owing if the lease is not being paid.

RCW 82.12.020 imposes a tax on every person in the State of Washington for the "privilege of using within this State as a consumer any article of personal property purchased at retail or acquired by lease ..."

(Emphasis supplied.)
As a general proposition, taxation is the rule and exemption is the exception. Adult Student Housing, Inc. v. State, Dept. of Revenue, 41 Wn. App. 583 (1985), Fibreboard Paper Products Corp. v. State, 66 Wn.2d 87 (1965). An exemption in a tax statute is strictly construed in favor of the application of the tax and against the person claiming the exemption. Yakima Fruit Growers Assn. v. Henneford, 187 Wn. 252 (1936).

RCW 82.12.0252 provides an exemption from use tax for property where its sale or use has already been subject to tax under either chapter RCW 82.08 or 82.12 and such tax has already been paid. No exemption is granted in the statute to cover the case of a lessee who is no longer making payments on its lease.

RCW 82.12.060 does allow the Department "[i]n the case of installment sales and leases of personal property" to, by regulation, "provide for the collection of taxes upon the installments of the purchase price, or amount of rental, as of the time the same fall due." Note that this does not allow the Department to excuse the payment of taxes on leased property but only to schedule its payment to coincide with the lease payment.

The fact that Broker is not making its lease payments does not excuse it from its obligation to pay use tax on the leased property. Broker did not pay the use tax on the property for

which it was primarily liable. We agree with the Audit Division and find Broker is primarily liable for payment of use tax due for the privilege of using the leased computer equipment and software.

III. In the alternative, does Escrow owe use tax on the use of computers and software leased by Escrow to Broker even though Escrow is not currently receiving lease payments from Broker?

The Department's Audit Division has assessed use tax on the property leased to Broker by Leasing. Escrow acquired the lease from Leasing and asserts that, because the lessee is not making the lease payments on the equipment, Escrow is not liable for paying use tax on the equipment and software. No exemption is provided for this eventuality in the statute.

In this instance, no evidence has been presented that retail sales tax was paid on the equipment and software leased to Broker by Leasing. Broker did not pay the use tax on the property for which it was primarily liable. Escrow, holder of the lease, is therefore secondarily liable for the use tax and must pay it if Broker fails to do so.

IV. Is the software for which a licensing fee is paid properly subject to use tax?

The Department's Audit Division has assessed use tax on the use of the computer software licensed for use by Broker, which asserts that it is not liable for the use tax because the licensing fee for computer software is not addressed by the statute.

RCW 82.12.020 imposes a tax on every person in the State of Washington for the "privilege of using within this State as a consumer any article of personal property purchased at retail or acquired by lease . . ." (Emphasis supplied.) WAC 458-20-155 (Rule 155) provides that the use of "standard, prewritten software" is subject to the use tax if the retail sales tax has not been paid for the software. Since Fannie Mae, as a federal agency, is not required to collect the retail sales tax, Broker is liable for the use tax on the use of the software and is required to report such tax on its tax returns.

The value of the software leased by Broker is readily determined by the amount of the lease paid for its use. RCW 82.12.010 defines "value of the article used" as the consideration "paid or given or contracted to be paid or given by the purchaser." Here the tax was imposed on the use of the software using as the measure of the tax the amount of the lease. Broker has not

refuted the valuation of the software, and we find the valuation proper.

As stated above in II, taxation is the rule and exemption is the exception. Fibreboard Paper Products Corp. v. State, 66 Wn.2d 87 (1965). No exemption exists here for the use of the software. We find that Broker is liable for use tax on the use of the computer software licensed for its use.

DECISION:

1. Amounts deposited in the escrow account established by Broker were properly excluded from its service income calculations by Broker.

2. Broker does owe use tax for its use of the computers leased originally from Leasing and currently from Escrow. The fact that Broker is not making lease payments on the equipment is not relevant to Broker's primary liability for use tax.

3. Escrow is liable for use tax on the equipment leased to Broker if such tax is not paid by Broker. The fact that Escrow is not currently receiving lease payments on the equipment is not relevant to Escrow's secondary liability for use tax.

4. Broker is liable for use tax on the software leased from Fannie Mae and valued at the amount of the licensing fee charged in the lease.

Taxpayer's petition is therefore granted in part and denied in part.

DATED this 24th day of December 1992.