

Cite as Det. No. 18-0211, 39 WTD 096 (2020)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Refund of)	<u>D E T E R M I N A T I O N</u>
Assessment)	
)	No. 18-0211
)	
...)	Registration No. . . .
)	

[1] Rule 19401; Rule 19402; Rule 19402A; RCW 82.04.462: B&O TAX – CONTRIBUTION - BENEFIT OF SERVICE - LOCATION OF CUSTOMERS RELATED BUSINESS ACTIVITIES: Taxpayer’s loan servicing fees for mortgages connected to real property located in Washington benefit its customers at the location of the real property upon which mortgages are placed.

[2] Rule 19402A: B&O TAX – INCOME APPORTIONMENT – RECEIPTS FACTOR – RECEIPTS FROM SERVICES: The numerator of the receipts factor includes Taxpayer’s loan servicing fees derived from loans secured by real property under Rule 19402A(4)(i). Since Taxpayer’s loan servicing fees are otherwise apportioned, the catch-all provision of Rule 19402A(4)(j) establishing a numerator of the receipts factor including receipts not otherwise apportioned under Rule 19402A(4) does not apply.

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 THE CASE

Gabriella Herkert, T.R.O. – A mortgage products and services provider protests apportionment of certain services fees to the state of Washington. Taxpayer contends that document review fees and closing charges are not “loan service fees” and should be apportioned as “receipts from services” using an alternative calculation of its costs of performance. We deny Taxpayer’s petition.¹

ISSUES

1. Pursuant to [RCW 82.04.462], and WACs 458-20-19401, 458-20-19402, 458-20-19404A, do Taxpayer’s receipts from various lenders for services related to mortgage loans secured by real property located in Washington constitute “loan service fees” attributable to Washington?

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

2. If the Taxpayer's costs of performance outside the state of Washington exceed Taxpayer's cost of performance in the state, is the Department of Revenue (Department) required to attribute Taxpayer's entire income from services related to those costs outside the state?

FINDINGS OF FACT

. . . (Taxpayer) provides home financing through a variety of mortgage types, including FHA, VA, USDA Rural Development, fixed-rate, and adjustable-rate mortgages. Taxpayer's headquarters is [out-of-state]. Taxpayer's corporate headquarters is [out-of-state]. In 2012, Taxpayer had 21-29 Washington employees with a total payroll of \$. . . million. In 2013, Taxpayer had 18-28 employees with a total payroll of \$. . . million. Taxpayer maintained at least one employee in the state of Washington through 2016.

Taxpayer directly provides home financing throughout the United States, including in the state of Washington. Taxpayer receives both interest and non-interest income for providing the services. Taxpayer is an affiliate of Among other activities, Taxpayer also subservices loans whereby it does the administrative work of managing loan payments, including collecting interest, principal and escrow payments from borrowers on behalf of its affiliates, which are the actual lenders or owners of the loan. Typically, Taxpayer receives a percentage of the unpaid principal balance of the loans it services in payment for providing subservice fees from the actual owner of the mortgage. Taxpayer also receives late fees and other income directly from borrowers for subservicing mortgage loans owned by its affiliates. Taxpayer's accounts include all fees as either "mortgage loan" or simply "loan" with additional descriptions, including closing charges, document review, application fee, modification/assumption fee, origination fee, late charges unrelated to yield, loan processing fees and other fees unrelated to yield. All of the fees listed in Taxpayer's accounts directly correspond to particular mortgage loans held by either it or another based on location of the underlying real property.

The Department's Audit Division (Audit) reviewed Taxpayer's books and records for the tax period of January 1, 2012, through December 31, 2012. Audit concluded that benefits commonly received by servicers of financial assets, as set forth in the Accounting Standards Codification issued by the Financial Accounting Standards Board (ASC 860-50)², should be included in Taxpayer's loan service fees. Audit included income from collecting principal, interest and escrow payments from borrowers, paying taxes and insurance from escrowed funds, monitoring delinquencies, executing foreclosures, investing funds pending distribution, remitting fees to guarantors and trustees, accounting for and remitting principal and interest payments to beneficial

² [Servicing of mortgage loans, credit card receivables, or other financial assets commonly includes, but is not limited to, the following activities:

- a. Collecting principal, interest, and escrow payments from borrowers
- b. Paying taxes and insurance from escrowed funds
- c. Monitoring delinquencies
- d. Executing foreclosure if necessary
- e. Temporarily investing funds pending distribution
- f. Remitting fees to guarantors, trustees, and others providing services
- g. Accounting for and remitting principal and interest payments to the holders of beneficial interests or participating interests in the financial assets

<https://www.iasplus.com/en-us/standards/fasb/broad-transactions/asc860>

holders in Taxpayer's loan service fees. Audit also included income from contracted servicing fees, document review fees, closing charges, interest from financial assets, late charges and other ancillary sources as loan service fees.³ Audit then attributed all loan service fees related to mortgages held by borrowers in Washington to the state, whether or not the Taxpayer was the owner of the mortgage or provided those services to the owner. As a result, Taxpayer received a credit of \$. . . for tax year January 1, 2012, through December 31, 2012.⁴ Taxpayer was assessed \$. . . for the tax period January 1, 2013, through December 31, 2013.⁵

Taxpayer timely requested review of its assessment. Taxpayer asserts that Audit read the definition of loan servicing fees too broadly by including fees generated at the time the loan is created as well as servicing fees generated afterward. Taxpayer contends that certain fees, including document review fees and closing charges that Audit included as loan servicing fees apportionable to the location of underlying real property, were actually receipts from services apportionable using a cost of performance analysis. Taxpayer further contends that out-of-state computer systems and data farms facilitate its loan servicing activities and should be included in Taxpayer's cost of performance outside the state of Washington. Taxpayer requests refunds of its B&O tax based on a cost of performance analysis for tax years 2012 and 2013.

ANALYSIS

In Washington, "there is levied and collected from every person that has a substantial nexus with this state a tax for the act or privilege of engaging in business activities." RCW 82.04.220. Taxpayer does not dispute that it has nexus with Washington, and is, therefore, generally subject to B&O tax in Washington. The B&O tax measure is "the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be." *Id.* The rate used is determined by the type of activity in which a taxpayer engages. *See generally* chapter 82.04 RCW.

The B&O tax is "extensive and is intended to impose . . . tax upon virtually all business activities carried on in the State." *Analytical Methods, Inc. v. Dep't of Revenue*, 84 Wn. App. 236, 241, 928 P.2d 1123 (1996) (quoting *Palmer v. Dep't of Revenue*, 82 Wn. App. 367, 371, 917 P.2d 1120 (1996)). "Business" is defined broadly to include "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly." RCW 82.04.140.

1. Loan Service Fees

RCW 82.04.460(1) provides:

Except as otherwise provided in this section, any person earning apportionable income taxable under this chapter and also taxable in another state must, for the

³ Taxpayer included income from the contested services in its accounts

⁴ Document No. . . . includes a credit for Service and Other Activities B&O tax of \$. . . and credit of \$. . . of interest.

⁵ Document No. . . . includes Service and Other Activities B&O tax of \$. . . and \$. . . in interest. Document . . . was adjusted on June 9, 2017, to reflect interest of \$. . . and additional interest of \$. . . , as well as a payment of \$. . . made on February 13, 2014.

purpose of computing tax liability under this chapter, apportion to this state, in accordance with RCW 82.04.462, that portion of the person's apportionable income derived from business activities performed within this state.

To determine taxable income in such cases, a taxpayer's total apportionable income is multiplied by a fraction referred to as the "receipts factor." RCW 82.04.462(3)(a). The numerator of the receipts factor is Washington apportionable receipts and the denominator is the worldwide apportionable receipts minus "throw-out income." *See id.*; WAC 458-20-19402(402). RCW 82.04.462(3)(b) provides, in pertinent part:

[F]or purposes of computing the receipts factor, gross income of the business generated from each apportionable activity is attributable to the state:

(i) Where the customer received the benefit of the taxpayer's service or, in the case of gross income from royalties, where the customer used the taxpayer's intangible property. When a customer receives the benefit of the taxpayer's services or uses the taxpayer's intangible property in this and one or more other states and the amount of gross income of the business that was received by the taxpayer in return for the services received or intangible property used by the customer in this state can be reasonably determined by the taxpayer, such amount of gross income must be attributed to this state.

(ii) If the customer received the benefit of the service or used the intangible property in more than one state and if the taxpayer is unable to attribute gross income of the business under the provisions of (b)(i) of this subsection (3), gross income of the business must be attributed to the state in which the benefit of the service was primarily received or in which the intangible property was primarily used.

The result is that a taxpayer may not "drop down" to a lower cascading criterion unless the amount of gross income attributed to Washington cannot "reasonably" be determined.

WAC 458-20-19402 (Rule 19402) is the Department's administrative rule implementing RCW 82.04.462.⁶ Rule 19402(301) provides the following additional information regarding the attribution of apportionable income:

Receipts are attributed to states based on a cascading method or series of steps. The department expects that most taxpayers will attribute apportionable receipts based on (a)(i) of this subsection because the department believes that either the taxpayer will know where the benefit is actually received or a "reasonable method of proportionally attributing receipts" will generally be available. These steps are:

(a) Where the customer received the benefit of the taxpayer's service . . . ;

⁶ Rule 19402 was originally issued on an emergency basis on June 2, 2010. It was later amended a number of times on an emergency basis until it was permanently adopted on September 17, 2012.

(i) If a taxpayer can reasonably determine the amount of a specific apportionable receipt that relates to a specific benefit of the services received in a state, that apportionable receipt is attributable to the state in which the benefit is received. When a customer receives the benefit of the taxpayer's services in this and one or more other states and the amount of gross income of the business that was received by the taxpayer in return for the services received by the customer in this state can be reasonably determined by the taxpayer, such amount of gross income must be attributed to this state. This may be shown by application of a reasonable method of proportionally attributing the benefit among states. The result determines the receipts attributed to each state. Under certain situations, the use of data based on an attribution method specified in (b) through (f) of this subsection may also be a reasonable method of proportionally attributing receipts among states . . .

(ii) If a taxpayer is unable to separately determine or use a reasonable method of proportionally attributing the benefit of the services in specific states under (a)(i) of this subsection, and the customer received the benefit of the service in multiple states, the apportionable receipt is attributed to the state in which the benefit of the service was primarily received. Primarily means, in this case, more than fifty percent.

Rule 19402(301) goes on to describe additional cascading steps in the series that a taxpayer is to follow if either (a)(i) or (a)(ii) are not feasible. These additional steps mirror the steps described in RCW 82.04.462(3)(b)(iii) – (vii), listed, in part, above.

...

Rule 19402(305)(a) apportions receipts from servicing loans by non-financial institutions when real property secures the debt in the same manner as a financial institution attributes the same apportionable receipts. Likewise, Rule 19402(305)(c) specifically provides that activities including “servicing loans” must be attributed “in the same manner a financial institution attributes income under WAC 458-20-19404A”⁷ when real property does not secure the debt.

WAC 458-20-19404A (Rule 19404A) addresses how to determine the income attributed to a state for both financial institutions and for nonfinancial institutions, such as Taxpayer, that service loans. First, Rule 19404A(4)(a) establishes the receipts factor for determining apportionment, the numerator of which includes service and other activities income of the taxpayer in the state. The numerator of the receipts factor – receipts within the state – includes interest, fees and penalties imposed in connection with loans secured by real property in Rule 19404A(4)(b) and loan service fees in Rule 19404A(4)(i). . . . Then, Rule 19404A(4)(b)(i) includes “interest, fees, and penalties” imposed in connection with loans secured by real property as service and other activities income of the taxpayer apportionable to Washington when the loans are secured by real property located

⁷ [WAC 458-20-19404A describes the application of single factor receipts apportionment to gross income for financial institutions during the period June 1, 2010, through December 31, 2015. *See* WAC 458-20-19404(1)(e)(5). WAC 458-20-19404 is the rule describing the formula for the apportionment and allocation of net income of financial institutions for tax years starting on or after January 1, 2016. *See* WAC 458-20-19404(1)(c).]

within the state. Rule 19404A(4)(i)(ii) apportions loan service fees generated by servicing secured and unsecured loans of another to the location of the borrower.

In this case, both the location of the real property securing loans and the location of the borrower are the same. Audit apportioned loan service fees including interest, fees and penalties to Washington when the real property securing the loan (and the borrower) were in Washington. Thus, all loan servicing income Taxpayer received from the lenders related to real property located in Washington during the audit period are apportionable to Washington.

Here, Taxpayer concedes that amounts received from borrowers after the initial creation of the loan were loan servicing fees correctly apportioned based on the location of the underlying real property. Taxpayer contends however, that amounts received from its affiliates for administrative service activities, including document review fees and closing charges, undertaken for other lenders while creating the loan, including its own affiliates, were not loan service fees but rather receipts from other services which should be attributed outside the state of Washington based on costs of performance. We disagree.

In ascertaining the meaning of a particular word used in a statute or rule, the court must consider “both the statute’s subject matter and the context in which the word is used.” *Port of Seattle v. Dep’t of Revenue*, 101 Wn. App. 106, 112, 1 P.3d 607, 610 (2000). The language of a statute must be read in context with the entire statute and construed in a manner consistent with the general purpose of the statute. *See, e.g., Graham v. State Bar Ass’n*, 86 Wn.2d 624, 627, 548 P.2d 310 (1976). In general, references to commercial terms should be given the meaning commonly used in the regulated industry, absent clear legislative intent to the contrary. *See City of Spokane v. Dep’t of Revenue*, 145 Wn.2d 445, 452, 38 P.3d 1010 (2002); Det. No. 11-0347, 33 WTD 195 (2011); NORMAN J. SINGER, STATUTES AND STATUTORY CONSTRUCTION § 47:31, at 366-67 (6th ed. 2000). Technical words, or terms of art relating to trade, when used in the statute dealing with the subject matter of such trade, are to be taken in their technical sense. 2A NORMAN J. SINGER, SUTHERLAND STATUTORY CONSTRUCTION, § 47:29, at 260 (5th ed. 1992).

“Loan service fees” are not defined in WAC 458-20-19404A. . . . Audit considered “loan service fees” in the context of the heavily-regulated financial services industry. As such, “loan service fees” are a term of art or technical words related to the industry of extending credit for the purpose of buying real property. In determining legislative intent, Washington courts give effect to the technical meaning of technical terms and terms of art. *Foster v. Dep’t of Ecology*, 184 Wn.2d 465, 471, 361 P.3d 959 (2015) (citing *Swinomish Indian Tribal Cmty. v. Dep’t of Ecology*, 178 Wn.2d 571, 581, 311 P.3d 6 (2013)). The business activities included as loan servicing activities set forth in the Accounting Standards Codification issued by the Financial Accounting Standards Board (ASC 860-50) are included in “loan services” in the industry. Fees generated from those activities fall within the term of art “loan service fees.”

Taxpayer offered no relevant authority for its contention that loan service fees are only generated after the origination of the mortgage is complete or that fees charged for document review or closing charges as part of the origination of the mortgage are outside the scope of loan service fees. Furthermore, Taxpayer’s limited reading of the term “loan services” based on when the fees are generated is not supported in Rule 19404A. In Rule 19404A(4)(i), [“loan servicing fees”] include

. . . fees [“derived from loans” and does not include a temporal restriction.] Those fees are then apportioned according to Rule 19404A(4)(b). Rule 19404A [does not distinguish whether] loan service fees can [only] occur at origination or thereafter [and we decline to read such a restriction into the rule]. Rule 19404A then apportions both loan service fees dating from origination and those that occur after in the same manner – apportioned to the state in which the underlying real property or borrower is located. Audit appropriately included all costs associated with servicing loans related to real property according to the location of the real property as required in Rule 19404A(4).

2. Cost of Performance

Taxpayer contends its income from providing services, including document review and loan closing services, are more appropriately apportioned as receipts from services generally. Rule 19404A(4)(j)⁸ provides:

Receipts from services. The numerator of the receipts factor includes receipts from services not otherwise apportioned under this subsection (4) if the service is performed in this state. If the service is performed both inside and outside this state, the numerator of the receipts factor includes **receipts [from services] not otherwise apportioned** under this subsection, if a greater proportion of the activity producing the receipts is performed in this state based on cost of performance.

(Emphasis added).

Taxpayer offers an alternative calculation of its cost of performance. Taxpayer’s position, however, is moot. Receipts from services under Rule 19404A(4)(j) apportions receipts not otherwise apportioned under the rest of subsection (4). As discussed above, loan service fees are apportioned according to Rule 19404A(4)(b) to either the location of the underlying real property or the borrower. Having concluded that the fees charged were either loan servicing fees or interest, fees and penalties imposed in connection with real property, the fees in dispute have been otherwise apportioned in Rule 19404A(4). By its own terms, therefore, such receipts are “not receipts from services” in Rule 19404A(4)(j). The cost of performance apportionment method available in Rule 19404A(4)(j) for receipts from services is likewise not applicable.

DECISION AND DISPOSITION

Taxpayer's petition is denied

Dated this 8th day of August 2018.

⁸ WAC 458-20-19404 was updated, effective 1/8/2018, and no longer has a section entitled “receipts from services.” However, for the tax period in question in this determination, the “receipts from services” section in the previous version of Rule 19404A, at Rule 19404A(j), is applicable.