

Cite as Det. No. 18-0041, 38 WTD 158 (2019)

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

In the Matter of the Petition for Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 18-0041
)	
...)	Registration No. . . .
)	

[1] RULE 254; RCW 82.32.100: RETAIL SALES TAX – RETAILING B&O TAX – RECORDKEEPING – REASONABLE ESTIMATES. Where a title insurer did not provide accurate records of where it earned its income from abstract, title insurance, and escrow services, the Department reasonably estimated the title insurer’s income by using a nationally-used form for reporting insurance premium and loss information.

[2] RCW 82.32.730 – SOURCING ABSTRACT, TITLE INSURANCE, AND ESCROW SERVICES. Income from abstract, title insurance, and escrow services is generally sourced to the closing location when a purchaser receives and makes first use of these services at the closing location.

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.

Sattelberg, T.R.O. – A national title insurer (“Taxpayer”) protests the Department of Revenue’s (“Department”) assessment of retail sales tax, retailing business and occupation (“B&O”) tax, and service and other activities B&O tax. Taxpayer argues that the Department overstated its income by erroneously (1) using insurance premium reporting documents to estimate Taxpayer’s income, and (2) using an estimated percentage to calculate its income from certain sales. We deny the petition in part, grant it in part, and remand it for additional records.¹

ISSUE

Did the Department erroneously estimate Taxpayer’s income either by using insurance premium reporting documents to estimate income or by using an estimated percentage to calculate the amount of its income from certain sales under RCW 82.32.100?

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

FINDINGS OF FACT

Taxpayer provides title insurance, abstract, and escrow services for residential and commercial sales of real property on a national basis. Title insurance, generally, insures against the risk that there are defects in the title of real property a lender is lending against or that a purchaser is purchasing. Abstract services, generally, are the inspection of the state of title through historical title records on a per-county basis. Escrow services, in the real property context, are generally the holding of evidence of title to real property and issuance of that title once instructions to issue it have been given. In addition to these three services, Taxpayer also performs other miscellaneous services related to real property sales.²

Taxpayer has branch locations throughout the country, including in Washington, and has larger, nationally-oriented locations [out of state]. Taxpayer also has an affiliated business entity (“Affiliate”) that operates branch locations throughout Washington.

Taxpayer performs its services for both local and national lending institutions. Taxpayer always issues the title insurance in real property sales it is involved with, but does not always perform the abstract and escrow services. The abstract and escrow services are generally performed under one of three main scenarios: 1) Taxpayer performs the abstract and escrow services itself from a branch office in Washington, 2) Taxpayer performs the abstract and escrow services itself from a national location, or 3) Taxpayer has another entity perform the abstract and escrow services in Washington as its “title agent.” Taxpayer hired . . . Affiliate to be its title agent in Washington and also hired unaffiliated entities to perform those services as its title agent.

Under scenario 1, Taxpayer collected retail sales tax on all three of its primary services and paid retailing B&O tax on 100 percent of its income. Under scenario 2, Taxpayer did not collect retail sales tax or pay retailing B&O tax on its income from any of its services. Under scenario 3, Taxpayer’s title agent collected retail sales tax on the full amount of its abstract and escrow income, as well as Taxpayer’s title insurance services. The title agent remitted the retail sales tax it collected. The title agent kept the portion of income from the abstract and escrow services, approximately 88 percent, and paid retailing B&O tax on that amount. The title agent paid to Taxpayer the portion of income from Taxpayer’s title insurance services, approximately 12 percent. Taxpayer then paid retailing B&O tax on the portion received from its title agent.

Taxpayer represents that in 2010, it began to transition much of its residential title abstract and escrow services from its Washington branch offices either to Affiliate or to one of its nationally-oriented locations. Taxpayer’s shift from its Washington branch offices to its national locations was to consolidate transaction processing for national lenders in just a few locations. These two shifts, Taxpayer represents, led to a large decrease in retail sales tax and retailing B&O tax reported to Washington. Much of this income shifted to Affiliate, while the remainder shifted out-of-state, according to Taxpayer.³ Taxpayer states this shift was evidenced in its reporting, which declined from retail sales taxable transactions of approximately \$. . . reported in 2009 to \$. . . reported in 2012.

² Some of these services include extra title searches, report issuing fees, and other title-related fees.

³ Taxpayer represents that Affiliate’s income was approximately \$. . . in 2009 and had increased to approximately \$. . . in 2012.

In 2013, the Department’s Audit Division (“Audit”) began auditing Taxpayer’s book and records for the time period January 1, 2009, through December 31, 2012. Audit requested, and Taxpayer provided, copies of Taxpayer’s year-end trial balances for the audit period. Taxpayer provided Audit its form “Schedule T – Exhibit of Premiums Written” for each year of the audit period. Schedule T is a form developed by the National Association of Insurance Commissioners for insurance businesses to file premium and loss information with multiple state-level insurance commissioners. This table represents the pertinent information from Taxpayer’s Schedule Ts for Washington from the audit period:

	Direct	Premiums	Written	
		Agency	Operations	
	Direct Operations	Non-affiliated Agencies	Affiliated Agencies	Other Income
Year	Column 3	Column 4	Column 5	Column 6
2009
2010
2011
2012

Taxpayer’s decrease in column 3 over the period, from approximately \$. . . to \$. . . , along with the accompanying increase in column 5, from approximately \$. . . to \$. . . , is consistent with its explanation of its shift of Washington business from itself to Affiliate.

Taxpayer also provided Audit a large amount of data from individual real estate sales transactions. Based on the volume of information Taxpayer provided, Audit decided a statistical sampling of Washington transactions was appropriate to determine allocation percentages of services provided in Washington versus out of state. This would have allowed Audit to allocate income between the first two scenarios listed above, namely, where the abstract and escrow services were provided.

On July 31, 2015, Audit requested documentation supporting transactions from three [strata] of Taxpayer’s business. Taxpayer eventually provided some documentation from each of these [strata], the majority of which were settlement statements. However, Audit found that there was insufficient information provided for a significant number of the transactions in the sample, as some settlement statements did not individually identify the amount Taxpayer had charged and recorded for its services. Further, Audit found that approximately 50 percent of the settlement statements had closing locations in Washington, while the other 50 percent had closing locations [out of state]. Audit concluded that buyers of Washington properties were not likely to be travelling [out of state] 50 percent of the time for their real property closings. This, combined with the other sampling problems, led Audit to disregard the sample.

Since Audit had concluded that the sample was unusable, it had to find another method to determine Taxpayer’s taxable income. In order to calculate Taxpayer’s gross income from retail sales, or income from scenarios 1 and 2, Audit first compared Taxpayer’s trial balances to its reporting over the audit period. Generally, Audit assessed retail sales tax and retailing B&O tax on the amount the trial balance exceeded Taxpayer’s reporting. Then, Audit considered column 6

from the Schedule Ts, “Other Income,” as retail sales in the absence of documentation to the contrary, and assessed retail sales tax and retailing B&O tax on that income.

Next, Audit estimated Taxpayer’s income from title agents, as described in scenario 3 above. Audit first added columns 4 and 5 from Taxpayer’s Schedule Ts together to establish a gross amount. Audit then multiplied this gross amount by 18 percent, a percentage it states Taxpayer represented was within its contractual rate

Finally, in order to calculate Taxpayer’s service income, Audit compared the service income in Taxpayer’s trial balances to its service income reporting over the audit period. Audit assessed service and other activities B&O tax on any amounts where the trial balances exceeded Taxpayer’s reporting. On December 9, 2016, Audit assessed Taxpayer \$⁴

Taxpayer timely sought administrative review raising two issues. First, Taxpayer argues that Audit improperly sourced sales to Washington that should have been sourced out of state. Taxpayer argues that the closing location is where sales should be sourced to, and as many of the sales of real property located in Washington were in fact closed in the [out-of-state] office location, Taxpayer claims those sales should be sourced out of state. As Taxpayer argues Audit improperly sourced sales to Washington, it correspondingly argues that Schedule T was an improper source from which to estimate income. Taxpayer states the Schedule Ts are prepared for reporting to state insurance commissioners and are not prepared for tax purposes. As such, Taxpayer argues, Audit should have disregarded its Schedule Ts when determining Taxpayer’s income, and instead sourced sales to the closing location. To support its argument, Taxpayer provided copies of some correspondence from within the Department indicating that real property sales should be sourced to the escrow agent’s closing location. Taxpayer provided a set of closing instructions from a lender to one of Taxpayer’s title agents detailing what the appropriate steps are for the agent to undertake when closing the transaction. Taxpayer also provided two samples of settlement statements for sales of real property in Washington. In one sample, the “Place of Settlement” box is a location within Washington, while in the other sample, the “Place of Settlement” box is a location [out of state].

Second, Taxpayer argues that the 18 percent figure Audit used when calculating retailing B&O tax from title agents is erroneous. Taxpayer argues that the actual percentage should be 12 percent, and provided copies of several contracts to support its argument. Taxpayer provided the contract with Affiliate showing a rate of 12 percent, and four other contracts showing similar percentages.⁵

⁴ Audit initially assessed Taxpayer a total of \$. . . on March 27, 2015. Shortly thereafter, Audit corrected the assessment, issuing its first post-assessment adjustment on April 15, 2015, for a total of \$ Later, Audit issued a second post-assessment adjustment, consisting of \$. . . in retail sales tax, \$. . . in retailing B&O tax, \$. . . in service & other activities B&O tax, \$. . . in use tax, \$. . . in delinquent penalties, \$. . . in interest, and \$. . . in extension interest.

⁵ We note the contract between Taxpayer and Affiliate was entered into as of 2010, which is in the middle of the audit period. For purposes of this determination, we will assume that the 12 percent rate was effective for the entire audit period.

Other contracts Taxpayer provided were a contract with . . . showing a rate of 10 percent, a contract with . . . showing a rate of 12 percent, a contract with . . . showing a rate of 12 percent, and a contract with . . . showing a rate of 11 percent.

ANALYSIS

Washington imposes retail sales tax and retailing B&O tax on each retail sale in this state. RCW 82.08.020; RCW 82.04.250. The term “retail sale” includes title insurance, abstract, and escrow services. RCW 82.04.050(3)(a); WAC 458-20-156.

Every person liable for payment of excise taxes is required to keep and preserve for a period of five years, suitable records as may be necessary to determine the person’s tax liability. RCW 82.32.070. The law also requires the person to make those records open for examination at any time by the Department. *Id.*

The Department’s administrative rule regarding recordkeeping, WAC 458-20-254 (“Rule 254”), states in pertinent part:

It is the duty of each taxpayer to prepare and preserve all records in a systematic manner conforming to accepted accounting methods and procedures. Such records are to be kept, preserved, and presented upon request of the department or its authorized representatives which will demonstrate:

(i) The amounts of gross receipts and sales from all sources, however derived, including barter or exchange transactions, whether or not such receipts or sales are taxable. These amounts must be supported by original source documents or records including but not limited to all purchase invoices, sales invoices, contracts, and such other records as may be necessary to substantiate gross receipts and sales.

Rule 254(3)(b).

If a taxpayer fails to keep and preserve suitable records, the Department “shall proceed, in such manner as it may deem best, to obtain facts and information on which to base its estimate of the tax.” RCW 82.32.100(1). In the absence of suitable records, the Department has authority to estimate tax liability based on the facts and information it is able to obtain. RCW 82.32.100(2).

We have previously affirmed the Department’s authority to assess taxes based on a reasonable estimate. *See, e.g.* Det. No. 15-0350, 35 WTD 291 (2016). In order for a taxpayer to successfully challenge an estimated assessment, the taxpayer must show that the Department abused its discretion in formulating the estimate. Det. No. 13-0302R, 33 WTD 572 (2014). An abuse of discretion occurs when a decision rests on untenable grounds or is manifestly unreasonable. *Mayer v. Sto Indus., Inc.*, 156 Wn.2d 677, 684, 132 P.3d 115 (2006); *Kreidler v. Cascade Nat’l. Ins. Co.*, 179 Wn. App. 851, 861, 321 P.3d 281 (2014).

1. Estimating Income Using Schedule Ts

Here, Audit attempted to statistically sample Taxpayer’s records in order to establish percentages of income to allocate to Washington. Taxpayer failed to produce documents sufficient for Audit to adequately conduct the statistical sampling, so Audit could not establish any percentages to use for such an allocation. In the absence of suitable records, Audit used Taxpayer’s Schedule Ts to

estimate Taxpayer's income. Taxpayer's Schedule Ts derive their amounts reported from title insurance and similar services from the location of the underlying real property. Thus, all income related to real property sales in Washington was allocated to Washington. In the absence of suitable documentation to the contrary, we find this estimation method reasonable.

Taxpayer disagrees, arguing this method unreasonably allocated income to Washington that should be sourced out of state. Washington follows the Streamlined Sales and Use Tax Agreement ("SSUTA") for its sourcing of retail sales, as codified in RCW 82.32.730.⁶ RCW 82.32.730(1) provides the following hierarchy of where to source most retail sales:

(a) When tangible personal property, an extended warranty, a digital good, digital code, digital automated service, or other service defined as a retail sale under RCW 82.04.050 is received by the purchaser at a business location of the seller, the sale is sourced to that business location.

(b) When the tangible personal property, extended warranty, digital good, digital code, digital automated service, or other service defined as a retail sale under RCW 82.04.050 is not received by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser or the purchaser's donee, designated as such by the purchaser, occurs, including the location indicated by instructions for delivery to the purchaser or donee, known to the seller.

(c) When (a) and (b) of this subsection do not apply, the sale is sourced to the location indicated by an address for the purchaser that is available from the business records of the seller that are maintained in the ordinary course of the seller's business when use of this address does not constitute bad faith

RCW 82.32.730(9)(f) defines "receive" and "receipt" as:

[T]aking possession of tangible personal property, *making first use* of digital automated services or *other services*, or taking possession or making first use of digital goods or digital codes, whichever comes first

(Emphasis added.)

Taxpayer argues that consumers of its title insurance, abstract, and escrow services will generally "make first use" of them at the location of the transaction's closing. This is because this location is typically where the purchaser receives an itemization of the closing costs (including title insurance, abstract, and escrow services), accepts those documents, and pays for these costs. However, these services can be sourced to a location other than where the closing occurred if the purchaser received, accepted, and executed the documents at a different location. If this location is in Washington, regardless of whether the real property is located in Washington, then

⁶ SSUTA was signed into law on March 22, 2007. Laws of 2007, ch. 6, §501; *see also North Central Washington Respiratory Care Services, Inc. v. Dep't of Revenue*, 165 Wn. App. 616, 268 P.3d 972 (2011). SSUTA changed the manner in which sales are sourced for purposes of paying sales or use taxes to the appropriate jurisdictions, and became effective July 1, 2008. *Id.*

Taxpayer's income from these sales is properly sourced to Washington. If the closing is executed out-of-state and the purchaser received the title insurance, abstract, and escrow services at closing, then income from those sales is properly sourced out-of-state. While we agree with Taxpayer that these services will typically be sourced to where closing occurs, that is not always the case. And, more importantly here, Audit was unable to adequately determine where Taxpayer's purchasers received the services based on the records provided. [Thus, Audit formulated its estimate using RCW 82.32.730(1)(c), because the location of the real properties in Washington were the addresses "for the purchaser[s] that [were] available from the business records of the seller that [were] maintained in the ordinary course of the seller's business."]

Although we agree with Taxpayer on how to theoretically source sales, this is separate and distinct from providing documentation supporting a method regarding how to [estimate] Taxpayer's sales [in the absence of suitable documentation]. Thus, Taxpayer has not shown that Audit abused its discretion, or was "manifestly unreasonable," in formulating its estimate. Accordingly, we deny Taxpayer's petition on this issue.

2. Estimated Percentage from Sales of Title Insurance Only

To estimate Taxpayer's income from transactions in which it only provided title insurance, Audit took the amounts in Taxpayer's Schedule Ts, columns 4 and 5, and multiplied them by 18 percent. Audit claims Taxpayer represented the 12 – 18 percent rate range to it, and Audit chose to use 18 percent in its estimate. On review, Taxpayer argues that the correct rate is 12 percent, not 18 percent. Taxpayer points to its contract with Affiliate, which shows 12 percent, as well as to the other contracts it provided showing similar percent rates.

In light of the contractual documentation Taxpayer provided indicating that a 12 percent rate may be closer to the average rate than 18 percent, we remand to Audit for a complete review of the contracts Taxpayer has with its title agents. At a minimum, Audit must adjust its estimate based on the evidence that Taxpayer does indeed contract at the 12 percent rate. We also allow Taxpayer additional time to provide other contracts showing its rate when it only provided title insurance.

DECISION AND DISPOSITION

We grant Taxpayer's petition in part and deny it in part. We remand Taxpayer's petition with respect to the percentage used to estimate the retailing B&O tax from Taxpayer's title agents. We deny Taxpayer's petition regarding the sourcing of its title, abstract, and escrow services.

Dated this 7th day of February 2018.