

Cite as Det. No. 16-0334, 38 WTD 115 (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. 16-0334
)	
... )	Registration No. . . .
)	

RULE 19404A; RCW 82.04.460: B&O TAX – LOAN SERVICING INCOME – APPORTIONMENT. Loan service fees received by the lender are apportioned the same as interest on the loan. Loan servicing fees on secured loans are included in the numerator of the receipts factor if the property is located within this state, whereas loan servicing fees on unsecured loans are included in the numerator of the receipts factor if the borrower is located in this state. However, in the case of a subservicer, loan servicing fees are included in the numerator of the apportionment formula if the buyer is located within this state, without regard to whether the loan is secured or unsecured.

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.

Lewis, T.R.O. – A financial institution that receives income from subservicing mortgage loans petitions for correction of an assessment that apportioned its loan servicing income based on the location of the borrower. Taxpayer maintained that the subservicing income should be attributed to where the services are performed. We conclude that Taxpayer’s loan servicing income should be apportioned based on the location of the borrower as provided in WAC 458-20-19404[A]. The assessment is sustained.<sup>1</sup>

ISSUE

Whether Taxpayer’s subservicing income constitutes “loan servicing fees” apportioned to Washington based on the location of the borrower under Rule 19404[A](4)(i)(ii), or whether these activities constitute “receipts from services” apportioned to where the services are performed under Rule 19404[A](4)(j)?

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

## FINDINGS OF FACT

Taxpayer, a federally chartered savings bank, provides mortgage loan servicing and subservicing in the United States. Taxpayer's services include customer communications and support, escrow administration, cash management, investor accounting and reporting, default administration, payoffs and satisfactions, special products, and regulatory compliance and reporting. In addition, it offers reports on various aspects of subservicing program, such as telephone call statistics and turnaround time in answering customer requests.

Taxpayer's customers include banks, thrifts, credit unions, mortgage bankers, and other financial businesses across the country. While Taxpayer has several customers located within Washington, Taxpayer does not have any property or employees within Washington, nor does it perform any business activity within Washington [other than earning income from Washington customers].

The Department's interaction with Taxpayer began during January 2014, when the Department's Audit Division sent Taxpayer a letter of inquiry. The letter stated that the Department had obtained information that indicated that Taxpayer had economic nexus, which would require Taxpayer to register with the Department and pay excise tax on income earned within Washington. The letter requested Taxpayer to contact the Department.

Subsequently, Taxpayer contacted the Department and entered into a Voluntary Disclosure Agreement with the Department.<sup>2</sup> On December 11, 2014, the Department issued a \$ . . . assessment, which covered the period January 1, 2010, through June 30, 2014.<sup>3</sup> The audit narrative explained that Taxpayer established economic nexus with the Department because it received more than \$250,000 from subservicing loans on Washington homes. Most of the income was received from Taxpayer's largest Washington customer, the [Credit Union]. Taxpayer not only received subservicing income, but also income from providing ancillary functions, such as accounting and report generation. The Department treated the ancillary income the same as subservicing income because the activities were related to the subservicing activities. The audit narrative also explained Taxpayer lacked nexus with Washington prior to the establishment of economic nexus on June 1, 2010. Accordingly, Taxpayer did not have taxable income for the periods prior to June 1, 2010.

The subservicing income that Taxpayer receives is generated from providing services related to the purchase and sale of real property. Home purchases generally require the buyer obtain a loan from a financial institution. The loan has two components [or] assets: 1) the right to receive payment of the principal and interest, and 2) the right to service the loan. The party that holds the servicing asset (i.e., the right to service the loan) is referred to as the loan servicer.

The loan servicer's responsibilities are primarily ministerial and include collecting principal and interest from borrowers, paying property taxes, responding to borrowers' inquiries, and establishing and maintaining accounts for the deposit of borrowers' funds, among others. In payment for servicing the loan, the loan servicer receives a loan servicing fee [from the party with the right to receive the loan payment], which is most frequently [taken out of] the interest paid and calculated as a percentage of the . . . loan balance. In such a case where the loan service fee is

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<sup>2</sup> Voluntary Disclosure Agreement . . . .

<sup>3</sup> The \$ . . . assessment consisted of \$ . . . tax and \$ . . . interest.

subject to the risk of default, if the buyer does not makes its mortgage payment, the servicer does not receive a fee.

In some cases, the company that owns the loan servicing right . . . does not want to perform the actual servicing of the loan. In such a case, the loan servicer will hire another company to perform the loan servicing function under a subservicing agreement. The fact that the servicer may hire a subservicer to perform the servicing functions does not relieve the servicer from its servicing obligations. Unlike the loan servicing fee, the fee paid to the subservicer is a flat fee and is not subject to interest rate risk, risk of prepayment, or risk of default.

In this case, Taxpayer receives income from subservicing loans and providing other administrative services related to real property located within Washington. These services include collecting principal, interest, and taxes from borrowers and remitting [them] to customers, paying interest on escrow accounts, [maintaining] records to reflect status of taxes and other charges, maintaining delinquent mortgage servicing programs, generating reports, accounting for all activities, and performing additional administrative servicing when requested by Taxpayer's customers. In most cases, Taxpayer provides the services to the loan on a private-label basis.<sup>4</sup> In return for providing the services, Taxpayer is paid a flat fee of \$ . . . -\$ . . . per loan per month. Taxpayer does not own any portion of the loan and does not receive payments under any mortgage service loan documents or contracts. Taxpayer's contractual relationship is with the loan servicer.

Taxpayer disagreed with the assessment. Taxpayer's petition did not challenge that, since June 1, 2010, it has had economic nexus and an obligation to pay Washington business and occupation tax on income earned within Washington. Rather, Taxpayer's challenge to the assessment concerned the method of apportioning taxable income to Washington.

Taxpayer's petition maintained that the Audit Division erred when it treated Taxpayer's income as "loan servicing fees" apportioned to Washington based on the location of the borrower under WAC 458-20-19404[A](4)(i). Taxpayer maintained that the Audit Division should have treated the income as "receipts from services" apportioned to where the activity occurs under the provisions of WAC 458-20-19404[A](4)(j).

#### ANALYSIS:

Washington imposes upon "every person that has a substantial nexus with this state" a business and occupation ("B&O") tax "for the act or privilege of engaging in business activities" in Washington. RCW 82.04.220(1). The measure of the tax is the gross proceeds of sales, value proceeding or accruing, or gross income of the business. RCW 82.04.220. Taxpayer earns income from receiving loan-subservicing fees. Because this business activity is not taxable under any other provision of Chapter 82.04 RCW, it is taxable under the "catch-all" Service and Other Business Activities B&O tax classification under RCW 82.04.290(2).

RCW 82.04.460 allows for apportionment of the income taxable under RCW 82.04.290. The version of RCW 82.04.460 effective for the period after June 1, 2010, provides in part:

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<sup>4</sup> Private label basis means that all communications sent to the borrower contain the name of the servicer, Taxpayer's customer.

(1) 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 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.

(2) The department must by rule provide a method of apportioning the apportionable income of financial institutions, where such apportionable income is taxable under RCW 82.04.290. . .

. . .

In compliance with RCW 82.04.460(2) the Department issued WAC 458-20-19404[A] (“Rule 19404[A]”), which discusses income apportionment during the relevant tax period here. Rule 19404[A](1)(a) states:

. . . [Effective June 1, 2010, Washington changed its method of apportioning certain gross income from engaging in business as a financial institution. This rule addresses how such gross income must be apportioned when the financial institution engages in business both within and outside the state and applies to the period June 1, 2010, through December 31, 2015, only.]

Taxpayer is a federally chartered savings bank. As such, Taxpayer satisfies the definition of “financial institution” contained at Rule 19404[A] (3) (h)(iii). Accordingly, both Taxpayer and the Department agree that Taxpayer’s income should be apportioned according to Rule 19404[A], which pertains to financial institutions.

Rule 19404[A] addresses how financial institutions that receive loan servicing fee income should calculate the income taxable by Washington. Rule 19404[A](4)(i)(ii)<sup>5</sup> explains that:

If the taxpayer receives loan servicing fees for servicing either the secured or the unsecured loans of another, the numerator of the receipts factor includes such fees if the borrower is located in this state.

Rule 19404[A] does not provide a definition of “loan servicing fees.” RCW 31.04.015(28) defines “service or servicing a loan” on behalf of the lender or investor of a residential [mortgage] loan to mean:

(a) Collecting or receiving payments on existing obligations due and owing to the lender or investor, including payments of principal, interest, escrow amounts, and other amounts due; (b) collecting fees due to the servicer; (c) working with the borrower and the licensed lender or servicer to collect data and make decisions necessary to modify certain terms of

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<sup>5</sup> While Rule 19404[A](4)(i) does not speak in terms of “attributing,” the rule generally treats the method for determining the numerator of the receipts factor for apportionment purposes as also being the method for attributing income to a state. *See* Rule 19404[A](2)(a).

those obligations either temporarily or permanently; (d) otherwise finalizing collection through the foreclosure process; or (e) servicing a reverse mortgage loan.

12 CFR § 1024[.1(b)] defines servicing as:

. . . [receiving] any scheduled periodic payments from a borrower pursuant to the terms of any federally related mortgage loan, including amounts for escrow accounts under section 10 of RESPA (12 U.S.C. 2609), and making the payments to the owner of the loan or other third parties of principal and interest and such other payments with respect to the amounts received from the borrower as may be required pursuant to the terms of the mortgage servicing loan documents or servicing contract. In the case of a home equity conversion mortgage or reverse mortgage as referenced in this section, servicing includes making payments to the borrower.

Here, Taxpayer is hired by the servicer of record to service a mortgage loan. Taxpayer does not own the loan servicing rights. Rather, Taxpayer is paid a flat fee to provide the loan servicing services. The Audit Division maintained that the loan-servicing income is attributed to Washington if the borrower is located in this state. Rule 19404[A](4)(i). Taxpayer disagrees, maintaining that its subservicing income is not earned for “servicing . . . loans of another.” Rather, Taxpayer claims that the income is best characterized as “receipts from services,” which is apportioned differently. Rule 19404[A](4)(j) explains:

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.

Even though the activities performed by Taxpayer are undeniably loan servicing functions, Taxpayer maintains it is only providing ministerial services. The distinction that Taxpayer draws between its activities and that of a loan servicer is based on the status of the parties, rather than the activities performed. The distinction Taxpayer maintains is based on the facts that:

- A real estate loan has two asset components: repayment of the amount loaned and payments for servicing the loan. The loan servicer of record treats the loan servicing asset, for accounting purposes, as an asset. The loan servicing asset, like the right to repayment of the principal of the loan, may be sold or kept. Taxpayer only accounts for the income it receives from being a loan servicer. Taxpayer does not carry a loan servicing asset on its books, because it is not the loan servicer.
- The loan servicer has privity of contract with the borrower either as being a party to the original loan or through the sale of the servicing rights. Taxpayer only has a contract to perform certain enumerated services for the loan servicer. Taxpayer has no privity of contract with the borrower.

- The loan servicer receives a payment based on interest rate and loan balance of the amount borrowed. Taxpayer receives a set amount for servicing the loan. There is no risk of not being paid if the borrower does not pay.
- While Taxpayer is hired to perform certain loan servicing functions, the legal responsibility for the performance of those functions remains with the loan servicer of record. To eliminate confusing the borrower, Taxpayer's contact with the borrower is portrayed as that of the loan servicer itself.
- The loan servicer is undoubtedly reporting income based on the provisions of Rule 19404[A](4)(i)(i)(A)] and would expect the provider of services to the loan servicer to report using the provisions of Rule 19404[A](4)(j).

The difference that Taxpayer draws does not translate to a difference in how a loan servicer and sub-servicer should be taxed under the applicable rule. [Even assuming all of Taxpayer's factual representations are true, it is the nature of Taxpayer's activities, and not its status as a sub-servicer, that is determinative.]

Rule 19404[A] explains the apportionment of income received by financial institutions. Loan service fees received by the lender are apportioned the same as interest on the loan. Loan servicing fees on secured loans are included in the numerator of the receipts factor if the property is located within this state, whereas loan servicing fees on unsecured loans are included in the numerator of the receipts factor if the borrower is located in this state. Rule 19404[A](4)(i)(i)(A) and (B). However, Rule 19401[A](4)(i)(ii) provides:

If the taxpayer receives loan servicing fees for servicing either the secured or the unsecured loans of another, the numerator of the receipts factor includes such fees if the borrower is located in this state.

Thus, in the case of a subservicer like Taxpayer, loan servicing fees are included in the numerator of the apportionment formula if the buyer is located within this state, without regard to whether the loan is secured or unsecured. Accordingly, we sustain the assessment.

#### DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 13th day of October 2016.