



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
STOCKHOLDERS LIQUIDATING CORPORATION)

Appearances:

For Appellant: Harvey A. Harkness and Bert A. Lewis,
Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel;
Crawford H. Thomas, Associate Tax Counsel

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STATE BOARD OF EQUALIZATION

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Stockholders Liquidating Corporation for refund of franchise tax in the amounts of \$70,957.31, \$106,946.07, \$70,937.08 and \$23,162.97 for the income years ended April 30, 1956, 1957, 1958, and 1959, respectively.

Appellant, formerly known as Western Mortgage Corporation, was incorporated in California on April 10, 1933. From the date of incorporation to the date of dissolution, August 13, 1959, appellant engaged exclusively in the business of acting as a "loan correspondent" for the Metropolitan Life Insurance Company under an agreement with the latter company. In the agreement appellant, expressed the desire to sell to Metropolitan loans evidenced by notes or bonds secured by mortgages or deeds of trust on improved real estate and thereafter to service the loans. The services included collecting payments, keeping records and making certain that the property which secured each loan was kept insured and that taxes upon it were paid. The agreement also stated that Metropolitan desired to purchase such loans as might be acceptable to it and that it wished appellant to perform the specified services.

Appellant made loans to individual borrowers which were secured by first mortgages or first deeds of trust. Some were government insured "FHA" or "VA" loans, while others were conventional or uninsured loans. A substantial number of such loans were similar to real estate loans made by national banks. All loans made were intended for subsequent transfer to Metropolitan and the latter was the recipient of all transfers made by appellant, Metropolitan always accepted the loans at the same interest rate previously negotiated with the borrower. Appellant, however, made

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an additional charge to Metropolitan in the amount of 1-1/2 percent of conventional loans and 1 percent of "FHA" or "VA" loans. These charges are characterized by appellant as "commissions." During the period under appeal all of the 12,000 loans made by appellant, except five, were accepted for purchase by Metropolitan. Such transfers usually occurred about 60 days after appellant made the loans. Appellant serviced only those loans originally made by it or its predecessor.

Appellant states that its general method of operation was as follows:

(i) On certain types of commercial loans and loans on various tracts of houses, it gets a commitment beforehand from Metropolitan that the insurance company will take up to a certain amount of loans on designated properties at designated terms.

(ii) On the general mortgage loan on a house, taxpayer gets no commitment beforehand, but it knows the maximum amount for the year which Metropolitan wants to loan on such loans, the standards which the loans must meet -- maximum length, rapidity of pay-off, ratio of loan to value, etc. -- and, therefore, it is confident that when it makes such a loan Metropolitan will take it.

(iii) In all of the above cases taxpayer makes the loan in its name and takes a trust deed and note in its favor from the borrower. The general pattern is that it will pledge these with a Bank, and the Bank will make a loan to the taxpayer secured by the pledge, the proceeds of which loan taxpayer remits to the borrower. The Bank then forwards all of this paper East to Metropolitan, which reviews it and has its appraiser appraise the properties involved out in the California area. Normally, between one and two months from the time the loan is made by the taxpayer, Metropolitan writes a letter to the taxpayer accepting that particular loan without recourse. As stated above, upon such event, taxpayer is relieved of all obligation on the paper as between it and Metropolitan; Metropolitan sends the funds to the Bank, which satisfies its loan to the taxpayer and remits an interest breakage amount to the taxpayer,

During the income years involved the number and value of loans sold by appellant to Metropolitan were:

	<u>Amount</u>	<u>Number</u>
1956	Not available	
1957	\$96,216,278.52	6558
1958	39,545,094.26	2940
1959	45,112,085.08	2359

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At the end of each fiscal year appellant held the following amount of loans made by it and not yet sold to Metropolitan:

1956	Mot available
1957	\$13,075,199.61
1958	5,089,317.54
1959	11,826,224.11

During the fiscal years 1956 through 1959 appellant had the following amounts of capital and surplus:

1956	\$ 3,553,062.59
1957	4,433,324.69
1958	4,150,512.59
1959	4,657,421.99

The amount of bank borrowings by appellant during the fiscal years 1956-1959 indicate the following year end balances owing to banks:

1956	\$17,533,112
1957	11,550,083
1958	3,169,211
1959	8,986,806

Appellant's returns reported the following gross income:

	<u>4/30/56</u>	<u>%</u>	<u>4/30/57</u>	<u>%</u>
Interest	\$ 977,508	12.51	\$ 699,604	10.18
Rent	9,052	.01	9,330	.01
Capital Gain or loss	(146)	.00	57,450	.08
Other Income	<u>6,828,444</u>	<u>87.38</u>	<u>6,105,556</u>	<u>88.85</u>
Total	<u>\$7,814,858</u>	<u>99.90</u>	<u>\$6,871,940</u>	<u>99.12</u>

	<u>4/30/58</u>	<u>%</u>	<u>4/30/59</u>	<u>%</u>
Interest	\$ 384,827	9.14	\$ 465,493	10.01
Rent	11,695	.28	16,554	.36
Capital Gain or Loss	27,705	.66		
Other Income	<u>3,786,234</u>	<u>89.92</u>	<u>4,162,216</u>	<u>89.63</u>
Total	<u>\$4,210,461</u>	<u>100%</u>	<u>\$4,644,263</u>	<u>100%</u>

"Other Income" primarily consisted of "commissions" on loans sold to Metropolitan and fees received by appellant for servicing the loans after they were sold.

The net interest income, after offsetting interest paid by appellant on amounts which it borrowed to make loans, was a minus figure of \$8,697 for the year ended in 1956, and plus figures of \$126,592, \$43,330 and \$198,185 for the years ended in 1957, 1958 and 1959, respectively. The entire net income was \$1,939,825, \$2,685,170, \$1,832,462 and \$2,294,270 for each of the respective years.

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The moneyed capital owned by appellant and invested in the loans of the type national banks made exceeded the net worth of some national banks in California and was substantial when compared to the net worth of others.

The nature and method of operation of appellant's business did not materially change from the date it commenced business in 1933 to the time it dissolved in 1959. Appellant regularly filed franchise tax returns and paid the tax imposed upon general corporations.

For the income years ended April 30, 1938, 1939 and 1940, the Franchise Tax Commissioner, the predecessor of the Franchise Tax Board, proposed to levy additional assessments on the ground that appellant was a financial corporation. The proposed assessments ~~were~~ protested and thereafter the Franchise Tax Commissioner determined that appellant was not a financial corporation. Several years later the Franchise Tax Commissioner again served on appellant notices of additional tax proposed to be assessed for the income years ended April 30, 1945, 1946 and 1947. These proposed additional assessments were once again predicted on the conclusion that appellant was a financial corporation. The appellant protested and appealed to this board following the action of the Franchise Tax Commissioner in affirming its classification. Prior to the hearing of the appeal the Franchise Tax Board, as successor to the commissioner, stipulated that appellant was not a financial corporation and that appellant was entitled to a refund of taxes paid under protest.

prior to 1939, another corporation engaged in a business substantially identical to that of appellant was treated by the Franchise Tax Commissioner as a financial corporation. In 1939 the commissioner was reversed in the trial court. (Winter Investment Co. v. Johnson, Sacramento Superior Court, No. 57305, decided Oct. 1939.) Again in 1942, the trial court reversed the commissioner's finding that a mortgage company such as appellant was a financial corporation. (Thomas Mortgage Co. v. McColgan, Sacramento Superior Court, No. 62077, decided Sept. 24, 1942.) In 1951 a memorandum by a member of respondent's legal staff, to the effect that corporations such as appellant are not financial corporations, was inserted in respondent's office manual. At two different times thereafter, and prior to the assessments here involved, the Franchise Tax Board made assessments against corporations similar to appellant on the ground that they were financial corporations, but later reversed itself. The final actions in those cases were in 1955 and 1958, respectively.

Presently, the Franchise Tax Board has taken the position that for the income years involved appellant was a financial corporation within the meaning of section 23183 of the Revenue and Taxation Code and was subject to the rate of tax imposed upon such corporations. The position of the Franchise Tax Board is based upon the conclusion that appellant was in competition with national banks. Appellant contends that it was not a financial corporation within the meaning of section 23183 and that it was merely an agent of Metropolitan.

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The principal question presented is whether appellant was properly classified as a financial corporation under section 23183 of the Revenue and Taxation Code so that it was taxable at the rate applicable to banks and financial corporations.

The courts have enunciated two tests which must be met before a corporation may be classified as a financial corporation under section 23183: (1) It must deal in money as distinguished from other commodities (Morris Plan Co. v. Johnson, 37 Cal. App, 2d 621 (100 P.2d 493)), and (2) it must be in substantial competition with national banks (Crown Finance Corp. v. McColgan, 23 Cal. 2d 280 (144 P.2d 331)).

Appellant did deal in money. It had its entire capital out on loan and borrowed large sums which it invested in loans.

With respect to the question of whether appellant was in substantial competition with national banks, national banks make a substantial number of real estate loans of the kind made by appellant, Appellant refers to the fact that in many cases it can loan larger amounts on real estate and for longer periods than national banks are permitted to do. But it is not logical to say that two concerns are not in competition because one offers more favorable terms than the other, (Crown Finance Corp. v. McColgan, 23 Cal, 2d 280 (144 P.2d 331).) The moneyed capital owned by appellant and invested in loans of the type national banks made exceeded the net worth of some national banks in California and was substantial when compared to the net worth of others.

Appellant points out that the bulk of its income was derived from servicing the loans after they were transferred to Metropolitan and that interest income was purely incidental and comparatively small. However, appellant serviced only those loans which it originally made. The focal point of competition with national banks was in making new loans and the subsequent transfers to Metropolitan did not reduce competition. In addition, we note that part of the income of a national bank on a real estate loan is attributable to servicing activities which it performs. The large amount of loans made in the very area in which national banks deal clearly portrays the presence of substantial competition.

Appellant's argument that it was merely an agent of Metropolitan must be rejected in view of our finding that appellant was dealing in its own moneyed capital rather than that of Metropolitan.

We have examined the previously mentioned trial court decisions, Winter Investment and Thomas Mortgage, which were favorable to taxpayers engaged in businesses similar to that of appellant. The Winter Investment decision was based on a finding that the loans were not of the type made by national banks because they were longer term loans of a smaller percentage of the value of the property and the Thomas Mortgage decision was based on a finding that the loans were not of the type made by national banks because the banks did not make loans for, or under commitment from, third parties. That technical differences in the forms of

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loans are not material to the question of whether a lender is competing with national banks was made apparent by the California Supreme Court in Crown Finance Corp. v. McColgan, 23 Cal. 2d 280, (144 P.2d 331), a case decided after the above trial court holdings* As we have found, appellant was engaged in loaning its own money to borrowers who were potential *customers* of national banks. That this activity constituted competition with banks is clear from the opinion in Crown Finance.

We conclude that appellant was a financial corporation within the meaning of section 23183,

Appellant argues that the Franchise Tax Board, through long established administrative practice in taxing it as an ordinary business corporation, has confirmed appellant's status as a nonfinancial corporation and that the interpretation should not now be reversed retroactively. It urges the applicability of the rule stated in Coca-Cola Co. v. State Board of Equalization, 25 Cal. 2d 918 (156 P.2d 1), that the contemporaneous administrative construction of a statute by those charged with its enforcement and interpretation, while not controlling, is entitled to great weight, and courts generally will not depart from such construction unless it is clearly erroneous or unauthorized. Appellant also stresses the treatment which the Franchise Tax Board has given to other corporations such as appellant.

We note that the Franchise Tax Board on two previous occasions has raised the question of whether appellant was a financial corporation and that in several instances it has raised the same question as to other companies in the same type of business. The vacillation and apparent uncertainty of the Franchise Tax Board in the correctness of its position would appear to negate the presence of any long established administrative interpretation that appellant, or corporations like it, were not financial corporations. However, even if it could be said that there was a long established administrative interpretation to that effect, we do not believe that such an interpretation would be authorized under the law.

A minor issue raised in this appeal relates to the treatment of loan commission expense for the income years ended April 30, 1958 and 1959. The Franchise Tax Board originally adopted the position that such expense taken as deductions on appellant's books should be capitalized as a part of the costs of the loans involved. The Franchise Tax Board has now conceded that appellant treated these items properly on its returns for the aforesaid income years and, consequently, that the Franchise Tax Board's adjustments were improper. The reductions in income for each year amount to \$58,590.50 for 1958 and \$22,302.99 for 1959.

