

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of )  
BALDWIN ANDHOWELL )

For Appellant: Albert F. Skelly  
Attorney at Law

For Respondent: Crawford H. Thomas  
Chief Counsel

Gary Paul Kane  
Counsel

O P I N I O N

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Baldwin and Howell against proposed assessments of additional franchise tax in the total amounts of \$11,022.08, \$11,406.63, \$14,337.27, \$10,120.48, \$12,315.32, \$10,248.75, \$9,577.31, \$8,571.54 and \$4,469.48 for the income years 1957, 1958, 1959, 1960, 1961, 1962, 1963, 1964 and 1965, respectively.

Appellant Baldwin and Howell is a California corporation and since 1949 its primary activity has been the business of acting as a "loan correspondent." Appellant has written agreements with approximately 12 institutional investors which provide for appellant's submission of loans for purchase. The investors are free to accept or reject a given loan. If it is accepted, the agreements provide for subsequent loan servicing by appellant. Some of the agreements give the investor the option to require the appellant to repurchase a loan within a certain period if any misrepresentations have been made. All of the agreements provide authority for termination of the relationship by either party. However, some of them require payment of a specified sum by the investor if it terminates without cause.

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Appellant's "loan correspondent" activity follows a general pattern. Initially appellant solicits loan applications, usually for single family dwellings, from builders, realtors, and the public. Once an application is received, appellant submits the information to an institutional investor. Appellant only proceeds when it receives the investor's written commitment that it will purchase the loan. The amount of the loan is then advanced by appellant to the borrower in exchange for a note and a first deed of trust. If a guaranteed loan is involved, the necessary documents are forwarded to the F.H.A. or V.A. In order to obtain immediate funds with which to repeat the process, appellant then pledges the loan with a bank as security for a loan of the same amount. Next, all documents are sent to the investor for its assumption of the borrower's loan without recourse to appellant. The investor then forwards the amount of the loan to the above bank which credits it against appellant's indebtedness. The average length of time that appellant holds the borrower's loan is 60 days.

Appellant states that the above procedure earned the following types and amounts of income over the period 1957-1960:

<u>Type of Income</u>	<u>Yearly Average</u>	<u>Percentage of Appellant's Total Yearly Average Income</u>
Net of commissions earned from borrowers less commissions paid	\$47,552	7.53%
Application fees	15,753	2 . 4 9
Interest income (to the extent that the rate of interest charged the borrowers exceeds the rate on bank loans)	11,145	1.76
Miscellaneous income	<u>1,091</u> <u>\$75,541</u>	<u>.18</u> <u>11.96%</u>

Respondent has submitted somewhat different figures; interest income is higher and commissions earned are not netted against commissions paid. These figures show that about 23.85% of appellant's total yearly income was earned by the above procedure.

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Appellant's remaining "loan correspondent" activity involves the servicing of loans assigned to investors. It collects the interest and principal payments and deposits them in a trust fund controlled by the investor, sees that fire and hazard insurance are furnished and that all taxes and assessments are paid, and reports to the investor all insurable losses and damage to the property. Appellant's fee for such servicing usually is a portion of, or based upon, the interest income it collects from the borrowers. Appellant states that the yearly average of these fees over the period 1957-1960 was \$394,090 or 62.38% of its total yearly average income. Figures submitted by respondent are less and show yearly average service fees were 5390% of appellant's total yearly average income,

In 1952 appellant created a subsidiary, Duke Mortgage Company, to act as trustee under the deeds of trust involved in the "loan correspondent" business. Appellant states that this additional corporation was necessary in order to separate trustee and beneficiary as required by law. Also the corporation was a financially attractive alternative to hiring a title company for this function. The subsidiary borrows the employees it needs from appellant.

The Internal Revenue Service conducted an audit of Duke Mortgage Company's federal returns for the years 1961-1964. The service determined that certain late charges, paid by borrowers because of late loan payments and reported by the subsidiary on its tax return, were attributable to appellant under section 482 of the Internal Revenue Code. Also, increases were made in the amounts exacted from the subsidiary by appellant for services performed (evidently for loaned employees). Appellant acquiesced in these adjustments.

Under the above facts respondent determined that appellant was a financial corporation, pursuant to section 23183 of the Revenue and Taxation Code, and should be taxed accordingly. Respondent also increased appellant's income by amounts identical to the federal audit adjustments, under section 24725 of the above code. These actions of respondent present the only issues of this case.

The financial corporation classification was created by the legislature to comply with the federal statute (12 U.S.C.A. § 548) prohibiting discrimination between national banks and other financial corporations. (Appeals of The Diners\* Club, Inc., Cal St. Bd. of Equal., Sept. 1, 1967.) The courts have held that a financial corporation

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is one which deals in moneyed capital, (The Morris Plan Co. v. Johnson, 37 Cal. App. 2d 621 [100 P.2d 493]), and which is in substantial competition with national banks. (Crown Finance Corp. v. McColgan, 23 Cal. 2d 280 [144 P.2d 331].)

Appellant first contends that it does not deal in moneyed capital, but rather deals in services. That is, it provides the service of initiating loans for various investors, and the services involved in collection and protection of these loans. However, this is an oversimplification. Appellant borrows funds from banks, loans these funds to customers in return for notes and deeds of trust, assigns these loans to investors, and then collects the payments. A portion of appellant's income is interest, or income based upon interest. These activities involve dealing in moneyed capital. (Marble Mortgage Co. v. Franchise Tax Board, 241 Cal. App. 2d 26 [50 Cal. Rptr. 345].)

We also think that appellants are in substantial competition with national banks. Such banks are expressly authorized to make loans secured by first liens upon improved real estate. (12 U.S.C.A. §371.) By actively soliciting and making this type of loan appellant is reducing the investment opportunities available to national banks, and is coming into direct competition with them. Moreover national banks themselves sell this type of loan to institutional investors. (See First Nat. Bank v. Hartford, 273 U.S. 548 [71 L. Ed. 767]; Marble Mortgage Co. v. Franchise Tax Board, supra.)

Appellant contends that, in effect, it is only acting as an agent for the institutional investors and consequently it is the investors, not appellant, which are in competition with national banks. Appellant cites Hoenig v. Huntington Nat. Bank of Columbus (1932) 59 F.2d 479, cert. denied, 287 U.S. 648 [77 L. Ed. 560], as support for this position. However appellant concedes that it is not "in the strict legal sense" an agent of the investors. Even if an agency relationship did exist, we are not convinced that it would be relevant. It is appellant that solicits and makes the loans, and then borrows more funds with which to repeat the process. The commission fees, loan application fees, interest income, and late charges, which appellant earns during the pre-assignment process, are the same kinds of income which a national bank earns when initially acquiring a real estate loan. These activities and types of income put appellant itself in the position of competing with national banks.

Hoenig v. Huntington Nat. Bank of Columbus, supra, does not alter this conclusion. The court used the agency

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concept only as an alternative ground for its holding, stating also that mortgage companies appealed to different borrower markets than national banks, and that even if competition did exist there was no discrimination under the state's system of taxation. In addition, the agency language of the case is inconsistent with the United States Supreme Court's holding in First Nat. Bank v. Hartford, supra, 273 U.S. 548 [71 L. Ed. 767]. (See Marble Mortgage Co. v. Franchise Tax Board, supra, 241 Cal. App. 2d 26 [50 Cal. Fr. 345].)

Appellant also contends that it only negotiates and sells the loans to investors in order to obtain the servicing business, from which it earns the vast majority of its "loan correspondent" income. Appellant argues that this servicing activity is not in competition with the activities of national banks. This same argument was made, and rejected by the court, in Marble Mortgage Co. v. Franchise Tax Board, supra. The court stated that one segment of the interest received by banks constitutes compensation for the performance of functions similar to the servicing performed by the taxpayer. The court concluded:

The banks are taxed at the bank rate with respect to all profits attributable to such activities. It would be discriminatory to allow mortgage companies like Marble to pay taxes at a lower rate for the earning of profits obtained from the performance of functions identical to those performed by national banks in relation to mortgages.

We must conclude that appellant was properly classified as a financial corporation under section 23183. Appellant's "loan correspondent" activities were in competition with activities of national banks, and this competition was substantial. (Appeals of Sterling Finance Corporation of California, Cal. St. Bd. of Equal., Mar. 25, 1968.)

The remaining issue of this appeal involves the correctness of respondent's action, based upon the federal audit, which attributed to appellant certain late charges reported by its subsidiary, and increased the amounts exacted from the subsidiary for appellant's services. Section 24725 provides:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly

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by the same interests, the Franchise Tax Board may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if it determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

A determination by respondent based upon a federal audit report is presumed to be correct, and the burden is upon the taxpayer to overcome this presumption. (Appeal of Harry and Tessie Somers, Cal. St. Bd. of Equal., Mar. 25, 1968; Appeal of Horace H. and Mildred E. Hubbard, Cal St. Bd. of Equal., Dec. 13, 1961.) In the instant situation appellant argues that the loaned employees are under the exclusive control of the subsidiary. However this does not conflict with respondent's increase of the amounts that appellant charged the subsidiary for the use of the parent's employees. Since appellant has not offered any other evidence or arguments, we must conclude that it has not carried its burden and therefore respondent's determination must be upheld.

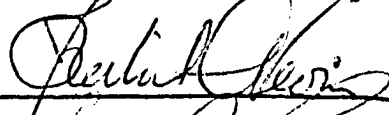

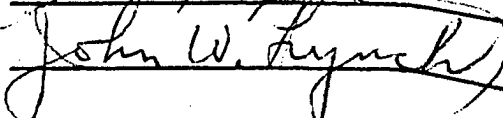
**O R D E R**

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code that the action of the Franchise Tax Board on the protests of Baldwin and Howell against proposed assessments of additional franchise tax in the total amounts of \$11,022.08, \$11,406.63, \$14,337.27, \$10,120.48, \$12,315.32, \$10,248.75, \$9,577.31, \$8,571.54 and \$4,469.48 for the income years 1957, 1958, 1959, 1960, 1961, 1962, 1963, 1964 and 1965, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of October, 1968, by the State Board of Equalization.

  
\_\_\_\_\_, Chairman  
  
\_\_\_\_\_, Member  
  
\_\_\_\_\_, Member  
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\_\_\_\_\_, Member

ATTEST:  Secretary