



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
FIRST INVESTMENT SERVICE COMPANY)

Appearances:

For Appellant: Thomas H. Carver
Attorney at Law

R. M. Anderson
President

For Respondent: Jack E. Gordon
Counsel

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 claims of First Investment Service Company for refund of-franchise tax in the amounts of \$922.03, \$2,316.92, \$1,702.06, and \$1,190.01 for the income years 1961, 1962, 1963, and 1964, respectively.

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After an audit of appellant's franchise tax returns for the income years 1961, 1962 and 1963 respondent determined that appellant was a financial corporation and that its income should be taxed at the higher rate applicable to those institutions. Notices of proposed assessments were issued and these were protested by appellant. Appellant's protests were denied and the additional assessments were affirmed by notices issued March 28, 1967. Subsequently, on April 28, 1967, a notice of proposed assessment for the income year 1964 was also issued reflecting a similar adjustment. Appellant did not protest that proposed assessment.

At that time appellant did not carry its disagreement any further. However, because of a temporary cash shortage, appellant was unable to make payment in full. Therefore, arrangements were made to pay the tax in installments and corporate stock was assigned to respondent as security. The arrangement was later modified and appellant retired the debt in the following manner:

<u>Date of Payment</u>	<u>Amount</u>
August 18, 1967	\$1,000.00
September 15, 1967	1,000.00
April 17, 1968	3,000.00
May 15, 1968	1,131.02

In accordance with its established procedure, respondent applied the payments received to the earliest years first. Accordingly, the deficiencies for the income years 1961 and 1962 were regarded by respondent as paid as indicated:

	<u>Income Year 1961</u>		
	<u>Assessment</u>	<u>Payment Date</u>	<u>Payment Application</u>
Tax	\$ 724.22		
Interest	198.66	8-18-67	\$ 922.88
	<u>\$ 922.88</u>		<u>\$ 922.88</u>

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Income Year 1962

	<u>Assessment</u>	<u>Payment Date</u>	<u>Payment Application</u>
Tax	\$1,869.03	8-18-67	\$ 77.12
Interest	435.08	9-15-67	1,000.00
		4-17-68	1,226.99
	<u>\$2,304.11</u>		<u>\$2,304.11</u>

On January 27, 1969, respondent received claims for refund of all the additional taxes assessed for 1961, 1962, 1963 and 1964. All of appellant's claims were denied on the basis that appellant was a financial corporation. The claim for income year 1961 was also denied in its entirety on the basis that it had not been filed within the period set forth in section 26073 of the Revenue and Taxation Code and was barred by the statute of limitations. The notice denying the claim for income year 1962 indicated that the statute of limitations barred refund of all but the \$1,226.99 received from the April 17, 1968, payment. Thereafter appellant filed a timely appeal from the denial of its claims with this board.

After a review of appellant's opening brief and documents supporting its contention that it was not a financial corporation respondent acceded to appellant's position in respect to income years 1961, 1962 and 1963. However, respondent maintained that the entire refund claim for income year 1961 and part of the claim for income year 1962 were barred by the statute of limitations. Appellant's refund claim for income year 1964, although timely, was denied by respondent on the ground that during its taxable year 1965 appellant was a financial corporation and was properly subjected to the higher tax rate applicable to such institutions for the income year 1964.

As we now view this matter it is respondent's position that appellant's claims for refund should be denied in the amount of \$922.03 for income year 1961, and \$1,077.97 for income year 1962 on the basis that they were not timely filed and are now barred by the statute of limitations. Respondent admits that the claim for income year 1963 is allowable in its entirety,

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but asserts that the claim for income year 1964 should be denied in the entire amount of \$1,190.01 on the basis that appellant was a financial corporation during its taxable year 1965 and was, therefore, taxable at the higher rate applicable to those institutions. Appellant maintains that the claims for 1961 and 1962 were timely filed and that with reference to income year 1964 it was not a financial corporation. Thus, we are faced with the determination of two primary issues: (1) whether appellant's claims for refund in the amounts of \$922.03 and \$1,077.97 for the income years 1961 and 1962, respectively, are barred by the statute of limitations; 1/ and (2) whether appellant was properly taxable at the rate for financial corporations for the income year 1964.

I

Whether appellant's claims for refund for income years 1961 and 1962 were barred by the statute of limitations.

Section 26073 of the Revenue and Taxation Code provides:

No credit or refund shall be allowed or made after four years from the last day prescribed for filing the return or after one year from the date of overpayment, whichever period expires the later, unless before the expiration of such period a claim therefor is filed by the taxpayer....

Appellant does not deny that its claims for 1961 and 1962 were filed more than four years after the due date

1/While, technically, the claim for refund for income year 1962 was in the amount of \$2,316.12, in view of respondent's concession and for convenience, we shall refer to the 1962 claim as if it were in the amount of \$1,077.97.

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of the returns and more' than one year after the August 18, 1967, and September 15, 1967, payments. Indeed, it cannot since the claims were not filed until January 1969. Thus, unless some reason exists for not applying the clear wording of the statute the claims are barred.

In mitigation of the effect of the statute of limitations appellant argues that because of the arrangement for installment payments, and because of the method of handling the security provided, the total tax due for all years in question should be regarded as one single **obligation** which was paid on May 15, 1968. Therefore, appellant asserts, no part of the claim should be barred since the claim was filed within one 'year of that date. In support of its position appellant urges that there was an agreement between the parties that **appellant's** liability as to any tax year was not extinguished until the total tax had been paid. Appellant maintains that it was agreed that there was a running account with all payments, for the purposes of the statute of limitations, to be regarded as made on the date of final payment,

On the other hand respondent denies the existence of any such agreement. **Respondent** steadfastly maintains that the only agreement was that the amounts due might be paid off in installments upon the deposit of sufficient **security and that there** was never any agreement that the payments would be applied in the manner claimed by appellant.

While it is true that a debtor may designate the debt to which a payment shall be applied, in the absence of such designation the creditor **may** apply the payment as he wishes. This rule is codified in section 1479 of the Civil Code which provides, in pertinent part:

Where a debtor, under several obligations to another, does an act, by way of performance, **in whole** or in part, which is equally applicable to two or more of such obligations, such performance must be applied as follows:

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One--If, at the time of performance, the intention or desire of the debtor that such performance should be applied to the extinction of any particular obligation, be manifested to the creditor, it must be so applied.

Two--If no such application be then made, the creditor, within a reasonable time after such performance, may apply it toward the extinction of any obligation, performance of which was due to him from the debtor at the time of such performance,...

* * *

Respondent maintains that in accordance with paragraph 2 of section 1479 and its established procedure it properly applied the payments to the earliest years first.

In support of the alleged agreement appellant relies on two letters to respondent, one dated August 23, 1967, and the other dated April 17, 1968. The August 23 letter provided that "you will find enclosed our check in the amount of \$1,000.00 which is to be credited to this account at this time...." The pertinent portions of the April 17, 1968, letter are as follows:

Enclosed you will find our check in the amount of \$3,000.00 in accordance with our recent discussion with 'you. It is our understanding that upon your acceptance of this payment, you will grant to First Investment Service Co. an extension to June 1, 1968, for the balance of the tax and assessments payable as outlined in your letter of assessment....

In the case of Moloney v. United States, 26 Am. Fed. Tax R.2d 5549, the court was called upon to construe certain instructions from a taxpayer to the Internal Revenue Service. In Moloney the taxpayer agreed to liquidate his tax liability by monthly payments of \$7,500.

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The taxpayer instructed the Internal Revenue Service to the effect that "...one-fourth of each such payment is to be credited to assessed interest and the balance, to assessed tax until the respective amounts are paid" The court found that this language was merely a general instruction to apply the payments to assessed tax and did not refer to any pro rata tax allocation. The court held that pursuant to such an instruction the government was entitled to follow its established procedure of extinguishing the deficiency for the earliest year first (See also Graper v. United States, 206 F. Supp. 173 179 180.).

Language such as that relied on by appellant indicates, at most that there was an agreement whereby appellant would pay the amounts due in installments. A perusal of other documents relied upon by appellant merely emphasizes this conclusion.

In an analogous situation the court in Gemological Institute of America, Inc. v. Riddell, 149 F. Supp. 137, 138, held that:

[T]he taxpayer; in paying the back taxes, not having designated the application of the payment to specific years and taxes, the Collector was justified in applying them as he did, both under the general law [citations] and under California law, California Civil Code § 1479, subd. 2.

In the case of Graper, supra, the taxpayer made the same argument made here by appellant, that the amounts owed for several years constituted a single obligation. In deciding against the taxpayer the court stated:

Taxpayer's argument that the deficiency owed by him constituted a single obligation and that the statute of limitations began to run only from the date of the last installment paid thereon, ignores the well-settled rule that "Each year (tax) is the origin of a new liability and of a separate cause of action."

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Commissioner of Internal Revenue v. Sunnen (1948) 333 U.S. 591 at 598, 6.8 S.Ct. 715, 719, 92 L.Ed. 898. That the parties treated the deficiencies as levied on a yearly basis is supported by the waiver forms which show the deficiency for each of the years in question set out separately along with penalties and interest thereon listed on the same line. (Grafer v. United States, 206 F. Supp. 173, 179; see also Anneal of W.J. Sasser, Cal. St. Bd. of Equal., Nov. 5, 1963.)

It is noted that in the instant case appellant received four notices of proposed assessment, four affirming notices of action, and that appellant filed separate claims for refund for each year which were denied by separate notices.

Appellant also contends that respondent treated the several assessments as a single obligation because it retained all the stock certificates assigned as security until the indebtedness was paid in full. It may first be observed that at no time did appellant ever request a partial release of the security. Respondent maintains that its policy is to make a partial release in cases where installment payments are being made if a return of part of the security would not jeopardize the full satisfaction of the liability. Such release, however, is made only upon request. In any event, four separate obligations are not-transformed into a single debt merely because of the method of handling security.

In conclusion it must be determined that appellant's claims for refund in the amounts of \$922.03 and \$1,077.97 for the income years 1961 and 1962, respectively, were barred by the statute of limitations and properly denied by respondent .

II

Whether appellant was properly taxable at the rate for financial corporations for the income year 1964.

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Prior to determining the major issue we are faced with the peripheral question whether appellant's status in income year 1964 or taxable year 1965 is controlling. Section 23183 of the Revenue and Taxation Code imposes an annual tax for the privilege of exercising its franchise within the state-upon a corporation's net income for the next preceding income year. Section 23041 defines "taxable year" as the fiscal year for which the tax is payable while section 23042 defines "income year" as the fiscal year upon the basis of which net income is computed. While the measure of the tax looks to the preceding income year the tax is paid for the privilege of exercising the corporate franchise during the taxable year. It follows that the status of the corporation during the year in which the privilege is exercised and paid for must be controlling. This has also been respondent's position since, at least, 1958. (FTB LR 007, Dec. 5, 1958.) While administrative determinations are not controlling, the existence of this practice for an extended period of time suggests legislative acquiescence in the respondent's statutory construction., (Great Western Financial Corp. v. Franchise Tax Board, 4 Cal. 3d 1, 7 [92 Cal. Rptr. 489, 479 P.2d 993].) Thus, we conclude that it is appellant's status during its taxable year 1965 which is controlling.

During the period in question appellant was a mortgage broker or loan correspondent who solicited loans from builders, realtors, and the general public. Initially, the loans were negotiated and made in its own name with appellant using its own funds or borrowed funds obtained pursuant to a previously established \$2,000,000 secured line of credit. Appellant bore the risk of loss on these loans, set the loan terms, and made collections in its own name. After making these loans appellant submitted them to either the VA or the FHA for approval. While awaiting approval appellant held the loans for periods ranging from 60 days to 18 months with the average period approximating, six months. Appellant received fees for originating the loans and all the interest earned prior to assignment.

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During 1965 appellant entered into agreements with four New York institutional investors. Each agreement was substantially similar and specified the type of loan the institution was willing to purchase, the purchase price, and the circumstances under which the loans could be rejected. Appellant's rights under the agreements could only be terminated by the assignee making specified payments. Servicing agreements, executed with the same institutions at about the same time as the purchase agreements, required that appellant protect the security by insuring that all taxes were paid, insurance maintained, and by making periodic inspections of the property. For providing such services appellant was paid a portion of the interest actually collected on the loans and was authorized to retain any late charges collected.

The following is a schedule showing the sources, amounts, and percentages of gross income received by appellant during taxable year 1965:

<u>Source</u>	<u>Amount</u>	<u>Percentage</u>
FHA and VA Origination Fees	\$156,366.39	30.43%
Construction Loan Origination Fees	29,807.00	5.80
Interest Earned	330,978.08	64.41
Loan Servicing Fees	8,576.63	1.67
Loss on Sale of Loans	(24,240.73)	(4.72)
Water Refunding Agreements	10,418.91	2.03
Miscellaneous	<u>1,970.22</u>	<u>.38</u>
Totals	<u>\$513,876.50</u>	<u>100.00%</u>

In 1965 appellant made loans in the amount and of the type set out below:

<u>Type of Loan</u>	<u>Number Of Loans</u>	<u>Percentage</u>	<u>Amount</u>	<u>Percentage</u>
Construction Loans				
Multiple Dwellings	5	.58%	\$ 227,000	1.40%
Commercial Properties	7	.80	505,500	3.10
FHA Insured Loans	612	70.18	10,548,000	65.60
VA Insured Loans	<u>248</u>	<u>28.44</u>	<u>4,806,925</u>	<u>29.90</u>
Totals	<u>872</u>	<u>100.00%</u>	<u>\$16,087,425</u>	<u>100.00%</u>

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During 1965 appellant assigned 726 loans, in the total amount of \$12,916,914, to institutional investors. Of these, 374, totaling \$6,579,421, were transferred to the four New York firms or to the Federal National Mortgage Association. Appellant retained the servicing function on these loans and received the appropriate remuneration therefor. The remaining 352 loans, in the amount of \$6,337,493 were sold to investors in the southern California area. Appellant did not continue to service these loans.

Based upon these facts we are asked to determine whether appellant is a financial corporation. The financial corporation classification set out in section 23183 et seq. of the 'Revenue and Taxation Code was created by the Legislature to comply with the federal statute (12 U.S.C.A. § 548) prohibiting discrimination in taxation between national banks and other financial institutions. (Crown Finance Corp. v. McColgan, 23 Cal. 2d 280 [144 P.2d 331]; The Morris Plan Co. v. Johnson, 37 Cal. App. 2d 621 [100 P.2d 493]; Marble Mortgage Co. v. Franchise Tax Board, 241 Cal. App. 2d 26 [50 Cal. Rptr. 345].) Although not defined in the statutes, the California courts have held that a financial corporation is one which deals in moneyed capital as opposed to other commodities and is in substantial competition with national banks. (Crown Finance Corp. v. McColgan, supra; The Morris Plan Co. v. Johnson, supra; Marble Mortgage Co. v. Franchise Tax Board, supra.) Therefore, we must determine whether appellant deals in moneyed capital in substantial competition with national banks.

A. Did appellant deal in moneyed capital as opposed to other commodities?

Appellant contends that it did not deal in money but only purchased trust deeds for the benefit of eastern institutional investors from whom it had already obtained a commitment. In other words appellant maintains that it deals only in a service.

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This argument has been advanced in the past but to no avail. (See First National Bank v. Hartford, 273 U.S. 548 [71 L. Ed. 767]; Marble Mortgage Co. v. Franchise Tax Board, supra; Appeals of Baldwin and Howell, Cal. St. Bd. of Equal., Oct. 7, 1968.) Appellant borrowed funds from a local bank pursuant to a secured line of credit. These funds, together with funds of its own, were loaned to customers in exchange for notes secured by trust deeds. Appellant set the terms, made collections, and bore the risk of loss. The loans were held for an average of six months and then most were sold to institutional investors. Approximately one-half were assigned to eastern institutional investors with appellant continuing to service the loans for a fee. The remaining one-half were transferred to southern California investors. A substantial portion of appellant's income constituted interest and FHA and VA loan origination fees. These items constitute charges for lending money and not charges for rendering a mere service.. In view of these facts and in line with the cited authorities it must be concluded that during the period in question appellant dealt in moneyed capital.

B. Was appellant in substantial competition with national banks?

It must also be concluded that appellant was in substantial competition with national banks. The acquisition of trust deeds by appellant reduces the investment opportunities available to national banks and places it in direct competition with them,, Furthermore, some national banks, themself-es, sell this type of loan to institutional investors. (First National Bank v. Hartford, supra; Marble Mortgage Co. v. Franchise Tax Board, supra; Appeals of Baldwin and Howell, supra.)

It was also asserted that appellant's operations were too minimal to be in competition with national banks. However, during the period in question the balance of appellant's capital stock account varied between approximately \$275,000 and \$294,000. During the same period the capital stock accounts of at least five national banks in the southern California area were less than that of appellant's, In the case of Marble Mortgage Co.,

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supra, where the taxpayer was held to be in substantial competition with national banks, the taxpayer's capital was only \$115,000. While the appellant in this matter made loans of over \$16,000,000 the taxpayer in Marble Mortgage Co. made loans of only \$14,000,000 and was held to be in substantial-competition with national banks. While not intending to set forth a precise numerical standard, it is noted that loans of \$113,000, \$87,000, and \$53,000 were found to constitute substantial competition with national banks in Appeal of Sterling Finance Corporation of California, Cal. St. Bd. of Equal., decided March 25, 1968.

For the reasons set out above respondent's action in this matter, in accordance with its concessions, is sustained.

O R D E R

Fursuant 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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of First Investment Service Company for refund of franchise tax in the amounts of \$922.03 and \$1,190.01 for the income years 1961 and 1964, respectively, be and the same is hereby sustained, and that the action of the Franchise Tax Board in denying the claims of First Investment Service Company for refund of franchise tax in the amounts of \$2,316.92 and \$1,702.06 for the income years 1962 and 1963, respectively, be and the same is hereby modified in accordance with respondent's concession. In all other respects the action of the Franchise Tax Board is sustained.

Done at-Sacramento, California, this 31st day of July, 1973, by the State Board of Equalization.

William G. Bennett, Chairman
W. W. Lynch, Member
John W. Lynch, Member
Paul Chan, Member
_____, Member

ATTEST: W. W. Lynch, Secretary