

**REDACTED DECISION -- 04-631 FN & 04-632 N -- BY ROBERT W. KIEFER, JR., ALJ
-- SUBMITTED for DECISION on DECEMBER 20, 2007 -- ISSUED on JUNE 23, 2008**

SYNOPSIS

BUSINESS FRANCHISE TAX AND CORPORATION NET INCOME TAX -- BURDEN OF PROOF -- In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon the Petitioner to show that any assessment of tax against it is erroneous, unlawful, void or otherwise invalid. *See* W. Va. Code § 11-10A-10(e) [2002]; W. Va. Code. St. R. §§ 121-1-63.1 and 69.2 (Apr. 20, 2003).

BUSINESS FRANCHISE TAX AND CORPORATION NET INCOME TAX -- ALLOWANCE FOR OBLIGATIONS SECURED PRIMARILY BY REAL PROPERTY AND OCCUPIED BY NONTRANSIENTS -- With respect to the allowances permitted by W. Va. Code §§ 11-23-3(b)(2)(E)(i)(III) [1991] and 11-24-6(f)(1)(C), the Petitioner has satisfied its burden of proof by showing that the loans for which the Petitioner obtained additional collateral are primarily secured by deeds of trust on residential property located in this state and occupied by nontransients.

BUSINESS FRANCHISE TAX AND CORPORATION NET INCOME TAX -- ALLOWANCE FOR CONSTRUCTION LOANS -- BINDING EFFECT OF TECHNICAL ASSISTANCE ADVISORY -- With respect to the allowances permitted by W. Va. Code §§ 11-23-3(b)(2)(E)(i)(III) [1991] and 11-24-6(f)(1)(C) [1998, 2007], the Petitioner has satisfied its burden of proof by showing that the construction loan in question is entitled to the allowance in accordance with Technical Assistance Advisory 93-002, which permits the allowance for “Construction Loans Which Represent A Direct First Lien On Residential Property Located In West Virginia And Occupied By Nontransients.”

BUSINESS FRANCHISE TAX AND CORPORATION NET INCOME TAX -- ALLOWANCE FOR CONSTRUCTION LOANS -- REQUIREMENT OF MODIFICATION OF A TECHNICAL ASSISTANCE ADVISORY -- The Respondent is bound by Technical Assistance Advisory 93-002 until such time as he puts all affected taxpayers on notice by modifying the technical assistance advisory in accordance with W. Va. Code § 11-10-5r [1986], and then only on a prospective basis.

BUSINESS FRANCHISE TAX AND CORPORATION NET INCOME TAX -- REQUIREMENT OF FILING OF PETITION FOR REFUND -- The Petitioner’s contention, that it is entitled to a refund because it is entitled to the allowance for SBA and USDA guaranteed loans in its portfolio, is not ripe for decision because the Petitioner has not filed a petition for refund.

BUSINESS FRANCHISE TAX AND CORPORATION NET INCOME TAX -- ALLOWANCE FOR GOVERNMENT OBLIGATIONS -- GUARANTEED LOANS NOT GOVERNMENT OBLIGATIONS -- Even if the Petitioner had filed a proper petition for

refund, it would not be entitled to the refund because the SBA and USDA guaranteed loans do not qualify for the allowance permitted by W. Va. Code §§ 11-23-3(b)(2)(E)(i)(I) [1991] and 11-24-6(f)(1)(A) [1998, 2007].

FINAL DECISION

A tax examiner with the Field Auditing “Division” (“the Division”) of the West Virginia State Tax Commissioner’s Office (“the Commissioner” or “the Respondent”) conducted an audit of the books and records of the Petitioner. Thereafter, on August 5, 2004, the Director of this Division issued a business franchise tax assessment against the Petitioner. The assessment was issued pursuant to the authorization of the State Tax Commissioner, under the provisions of Chapter 11, Articles 10 and 23 of the West Virginia Code. The assessment was for the period of January 1, 2001, through December 31, 2003, for tax in the amount of \$_____, and interest in the amount of \$_____, computed through May 31, 2004, for a total assessed tax liability of \$_____. Written notice of this assessment was served on the Petitioner some time after August 5, 2004.

Also, on August 5, 2004, the Commissioner (by the Division) issued a corporation net income tax assessment against the Petitioner, under the provisions of Chapter 11, Articles 10 and 24 of the West Virginia Code, for the for the period of January 1, 2001, through December 31, 2003, for tax in the amount of \$_____, and interest in the amount of \$_____, computed through May 31, 2004, for a total assessed tax liability of \$_____. Written notice of this assessment was served on the Petitioner some time after August 5, 2004.

Thereafter, by hand delivery on October 5, 2004, the Petitioner timely filed with this tribunal, the West Virginia Office of Tax Appeals, a petition for reassessment. W. Va. Code §§ 11-10A-8(1) [2002] & 11-10A-9(a)-(b) [2005].

Subsequently, notice of a hearing on the petition was sent to the Petitioner and a hearing was held in accordance with the provisions of W. Va. Code § 11-10A-10 [2002].

FINDINGS OF FACT

1. Petitioner is a state non-member, FDIC-insured, commercial bank that provides deposit and loan services for individuals and small businesses in several counties in West Virginia. (Transcript, p. 26).

2. At issue in this case is whether Petitioner correctly reported and remitted business franchise tax and corporate net income tax on all capital apportioned to West Virginia. (Petitioner's Exhibit Nos. 1, 2).

3. West Virginia provides an allowance reducing corporation net income tax and reducing the taxable capital on the franchise tax to the extent that a taxpayer has invested in certain qualifying assets, which include federal obligations, residential mortgages, West Virginia obligations and mobile home loans. (Transcript, p. 7).

4. To the extent that the Petitioner holds assets of this nature, it is entitled to reduce its taxable income or its taxable capital, as the case may be, for the qualifying assets, which is calculated by determining a percentage of its assets that are comprised by those qualifying assets. (Transcript, p. 7).

5. During the course of the audit, Respondent's auditor chose a list of loans (the "loan sample") to sample for purposes of determining whether Petitioner correctly reported business franchise taxes and corporate net income tax during the Audit Period. (Transcript, p. 30).

6. Respondent created a spreadsheet (the "spreadsheet") of the loan sample, which was admitted into evidence as Petitioner's Exhibit No. 4, and which details the note number,

borrower's name, balance of the loan, apportionment percentage and apportioned balance. (Transcript, p. 30; Petitioner's Exhibit No. 4).

7. For purposes of the audit, Respondent reduced the apportionment percentage and consequently, the apportioned balance, for the qualifying assets in three separate areas, which represent the three areas of controversy in this matter. (Transcript, p. 8, Petitioner's Exhibit No. 4).

9. The first area of controversy relates to "additional collateral residential loans," which are loans in which Petitioner has obtained a deed of trust on the residential property, but for which Petitioner also obtained additional collateral to enhance its collateral position. (Transcript p. 9, Petitioner's Exhibit No. 5).

10. With regard to these 'additional collateral residential loans,' Respondent reduced the apportionment percentage and amount where there is a mix of residential collateral and non-residential collateral, effectively reducing the allowance by the portion of the non-residential collateral in arriving at the allowance. (Transcript, pp. 8, 61).

11. The second issue in this matter involves construction loans, for which Respondent allowed no apportionment at arriving at the allowance. (Transcript, pp. 9, 60, 62).

12. Included in Petitioner's investment and loan portfolio during the audit period were certain securities and loans guaranteed by the Small Business Administration ("SBA") and the United States Department of Agriculture ("USDA"). (Transcript, p. 10).

13. During the course of the audit, Petitioner informed the Auditing "Division" that its computation of the allowance included as federal obligations SBA/USDA securities in Petitioner's investment portfolio, but omitted SBA/USDA loan obligations. (Transcript, pp. 10-11).

14. Petitioner requested that the Auditing “Division” adjust Petitioner’s original filed corporation net income tax returns for these additional SBA/USDA loans currently reflected in Petitioner’s loan portfolio. (Transcript, p. 11).

15. Although the Auditing “Division” did not exclude the SBA/USDA obligations included in Petitioner’s investment portfolio, it refused to adjust Petitioner’s original filed corporation net income tax returns for the additional SBA/USDA loans not originally included in computing the allowance. (Transcript, p. 11).

DISCUSSION

The issues presented by this matter relate to similar provisions in the business franchise tax and the corporation net income tax. The pertinent section of the business franchise tax, W. Va. Code § 11-23-3(b)(2) [1991], provides, in relevant part:

(E) Allowance for certain government obligations and obligations secured by residential property. – As to both corporations and partnerships, capital shall be multiplied by a fraction equal to one minus a fraction:

(i) The numerator of which is the average of the monthly beginning and ending account balances during the taxable year (account balances to be determined at cost in the same manner that such obligations, investments and loans are reported on Schedule L of the Federal Form 1120 or Federal Form 1065) of the following:

(I) Obligations and securities of the United States, or of any agency, authority, commission or instrumentality of the United States and any other corporation or entity created under the authority of the United States Congress for the purpose of implementing or furthering an objective of national policy;

* * * *

(III) Investments or loans primarily secured by mortgages, or deeds of trust, on residential property located in this state and occupied by nontransients; and

* * * *

(ii) The denominator of which is the average of the monthly beginning and ending account balances of the total assets of the taxpayer as shown on Schedule L of Federal Form 1120, as filed by the taxpayer with the Internal Revenue Service or, in the case of partnerships, Schedule L of Federal Form 1065, as filed by the taxpayer with the Internal Revenue Service.

The pertinent section of the corporation net income tax, W. Va. Code § 11-24-6 [1998, 2007], provides, in relevant part:

(f) Allowance for certain government obligations and obligations secured by residential property.

The West Virginia taxable income of a taxpayer subject to this article as adjusted in accordance with subsections (b), (c) and (e) of this section shall be further adjusted by multiplying the taxable income after the adjustment by said subsections by a fraction equal to one minus a fraction:

(1) The numerator of which is the sum of the average of the monthly beginning and ending account balances during the taxable year (account balances to be determined at cost in the same manner that obligations, investments and loans are reported on Schedule L of the Federal Form 1120) of the following:

(A) Obligations or securities of the United States, or of any agency, authority, commission or instrumentality of the United States and any other corporation or entity created under the authority of the United States Congress for the purpose of implementing or furthering an objective of national policy;

* * * *

(C) Investments or loans primarily secured by mortgages, or deeds of trust, on residential property located in this state and occupied by nontransients; and

* * * *

(2) The denominator of which is the average of the monthly beginning and ending account balances of the total assets of the taxpayer which are shown on Schedule L of Federal Form 1120, which are filed by the taxpayer with the Internal Revenue Service.

With respect to both taxes, the Respondent reduced the allowances permitted by these sections, which resulted in the two assessments that are the subject of this matter.

The Petitioner raises three separate issues. The first is whether certain mortgages owned by the Petitioner which are secured by deeds of trust on a residence, but which are also secured

by additional collateral, qualify in their full amount in computing the allowances pursuant to the provisions of W. Va. Code §§ 11-23-3(b)(2)(E)(i)(III) [1991] and 11-24-6(f)(1)(C) [1998, 2007]. The second is whether construction loans qualify for the allowances pursuant to the provisions of the same subsections. The third is whether certain of the Petitioner's investments qualify for the allowances pursuant to the provisions of W. Va. Code §§ 11-23-3(b)(2)(E)(i)(I) [1991] and 11-24-6(f)(1)(A) [1998, 2007].

The first issue to be decided is whether certain loans held by the Petitioner constitute “[i]nvestments or loans primarily secured by mortgages, or deeds of trust, on residential property located in this state and occupied by nontransients.” The loans at issue are secured by deeds of trust on residential property that is located in the State of West Virginia and is occupied by nontransients. In each instance, there is additional collateral securing the loan that is not residential property located in this state and occupied by nontransients. In reducing the allowance, the Respondent did not reduce the allowance claimed by the Respondent by the amount of the entire loan. Instead, he reduced the allowance by the percentage of the loan that is equal to the amount that the non-residential collateral bears to the all collateral securing the loan.

The Petitioner contests the reduction of the allowance. It maintains that the plain language of the statute permits the allowance where the loan is “primarily” secured by a mortgage or deed of trust on residential property occupied by nontransients. It maintains that the statutory language contains no requirement that the mortgage or deed of trust be entirely secured by residential real property occupied by nontransients. It also maintains that the statutory language cannot be read to permit a partial reduction in the allowance by that portion of the collateral that does not constitute residential real property occupied by nontransients.

This Office is of the opinion that the Petitioner's argument in this respect is correct. The statutes require only that a loan be “primarily secured by mortgages, or deeds of trust, on

residential property located in this state and occupied by nontransients.” There is no requirement that the loan be secured entirely by mortgages or deeds of trust on residential property located in this state and occupied by nontransients. There is nothing in the statute authorizing the Respondent to reduce the allowance by the percentage of the loan that non-residential collateral bears to the total collateral securing the loan. Thus, where the loan is primarily secured by mortgages, or deeds of trust, on residential property located in this state and occupied by nontransients, the Petitioner is entitled to the allowance for the entire loan regardless of the fact that there may be additional collateral securing the loan. The question, then, is whether the loans are primarily secured by deeds of trust on residential property located in this state and occupied by nontransients.

“Primarily” is defined as, “[P]rimarily . . . adv 1 : first of all : FUNDAMENTALLY, PRINCIPALLY” *Webster’s Third New International Dictionary, Unabridged*, Merriam, Springfield, Mass., 1966, p. 1800. “Fundamentally is defined as, “[F]undamentally . . . adv . . . : in a fundamental manner : in the manner of a primary source” *Id.* at 921. “Principally” is defined as, “[P]rincipally . . . adv . . . : in a principal manner : in the chief place or degree : PRIMARILY, CHIEFLY, MAINLY.” *Id.* at 1803. “Mainly” is defined as, “[M]ainly adv . . . 2 : in the principal respect : for the most part : CHIEFLY” *Id.* at 1362.

In light of the definition of “primarily,” and the definitions of the similar, if not synonymous, words “fundamentally,” “principally,” and “mainly,” this Office is of the opinion that the loans in this matter satisfy the statutory requirement. With respect to the three loans for which the Respondent reduced the allowance, the residential property is the primary or principal collateral securing the loans. In each instance, it appears that the loan would not have been made had the residential real property not been put up as collateral for the loan. The evidence in the record is that, in each instance, the appraised value of the residential real property exceeded the

remaining principal balance on the loan. These considerations provide compelling proof that the residential real property is the “primary” security for each of the loans.

Additionally, with respect to the three loans for which the Respondent partially reduced the allowance, the nonresidential real property is simply “additional” collateral. With all three of the loans that were secured by additional collateral, the additional collateral was vacant land. With one of the loans, in addition to vacant land, additional collateral also consisted of an apartment building.¹ There was evidence that in each instance, the value of the residence exceeded the value of the “additional” collateral. This evidence bolsters the conclusion that the additional collateral was simply extra security for the Petitioner, while the residential property was the primary collateral. For purposes of the statutory allowances, it is immaterial that the Petitioner has managed to obtain additional security for its loans.²

The second issue is whether or not a construction loan constitutes an “[i]nvestment[] or loan[] primarily secured by [a] mortgage[], or deed[] of trust, on residential property located in this state and occupied by nontransients.” The Petitioner contends that it is, arguing that there is nothing in the statute or legislative rules that provide a distinction merely because the collateral for the loan is a residence that is under construction. The Petitioner also relies on Technical Assistance Advisory No. 93-002, 1994 WL 81918 (1994), wherein the State Tax Commissioner determined that “Construction Loans Which Represent A Direct First Lien On Residential Property Located In West Virginia And Occupied By Nontransients” are “‘exempt classification’ assets in the computation of the fractional multiplier by which the corporation net income tax and business franchise tax exemptions are determined.” It further cites the fact that the interest

¹ There was testimony that, in rare instances, the Petitioner might accept additional collateral in the form of personal property. That was not the case with any of the loans in this matter.

² There could be instances where the residential property occupied by nontransients is not the primary collateral for a loan. However, that is not the case in this matter.

on the construction loan was deductible for purposes of the federal income tax in the same manner as is the interest on a loan for the purchase of a residence.

West Virginia Code § 11-10-5r [1986] provides, in relevant part:

(a) The tax commissioner may issue an informal technical assistance advisory to a person, upon written request, as to the position of his office on the tax consequences of a stated transaction or event, under existing statutes, rules or policies. . . .

(b) A technical assistance advisory shall have no precedential value except to the taxpayer who requests the advisory and then only for the specific transaction addressed in the technical assistance advisory, unless specifically stated otherwise in the advisory.

(c) Any modification of an advisory shall be prospective only.

* * * *

(e) The tax commissioner shall release copies of technical assistance advisories issued pursuant to this section to the public. Any identifying characteristics or facts about the taxpayer shall be omitted or modified in such technical assistance advisories to such an extent so as to not disclose the name or identity of the taxpayer.

While there is no evidence in the record to show that the technical assistance advisory was requested by or issued to the Petitioner in this matter, Technical Assistance Advisory No. 93-002 is expressly “declared to be of precedential value to other taxpayers.” Consequently, the Petitioner and other taxpayers were and are entitled to rely on the language in the technical assistance advisory to the effect that the construction loans may be used in computing the allowance for the business franchise tax and the corporation net income tax.

The Respondent contends that a construction loan does not meet the statutory definition. The statutory definition requires that the loan be “primarily secured by [a] mortgage[], or deed[] of trust, on residential property located in this state and occupied by nontransients.” The loan was secured by a deed of trust on property located in this state. The property securing the loan was also residential property, or at least it was intended to be. The problem, according to the

Respondent, is that the property was not occupied by nontransients. In all likelihood it was intended to be occupied by nontransients. However, according to the Respondent, it is not intent to occupy that satisfies the statute; it is actual occupation that satisfies the statute.

The problem with the Respondent's position is that one of his predecessors issued Technical Assistance Advisory 93-002, advising all taxpayers of the State of West Virginia that they were entitled to rely on that advisory. Presumably, taxpayers have relied on that advisory for close to fourteen years. Such taxpayers would likely include banks, savings and loans, mortgage companies and other financial institutions that make mortgage and construction loans. Clearly, the Petitioner relied on Technical Assistance Advisory 93-002. Other taxpayers are likely still claiming the allowance for construction loans in reliance on the advisory. Because they have not been audited or otherwise informed by the Respondent that the Respondent has altered his (actually his predecessor's) position, they are a position that is more favorable than that that in which the Respondent seeks to place the Petitioner. Alteration of the Respondent's position with the respect to the Petitioner, while allowing other similarly situated taxpayers to claim the allowance, violates equal protection principles, the Equal and Uniform Taxation provision of the West Virginia Constitution, W. Va. Const. art. X, § 1, and is simply unfair in that it puts the Petitioner at a competitive disadvantage compared with similarly situated taxpayers. The Petitioner relied on Technical Assistance Advisory 93-002, as permitted by statute. If the Respondent wishes to change the position articulated in Technical Assistance Advisory 93-002, in order to be fair to all taxpayers, he must do so in the manner contemplated by W. Va. Code § 11-10-5r [1986].

The Petitioner is entitled to the allowance with respect to the construction loan under consideration.

The third issue is whether certain of the Petitioner's investments constitute, "Obligations or securities of the United States, or of any agency, authority, commission or instrumentality of the United States and any other corporation or entity created under the authority of the United States Congress for the purpose of implementing or furthering an objective of national policy," as provided by W. Va. Code § 11-23-3(b)(2)(E)(i)(I) [1991] and 11-24-6(f)(1)(A) [1998, 2007]. The investments for which the Petitioner seeks the allowance in this matter are mortgage loans that are guaranteed by the Small Business Administration (SBA) and the United States Department of Agriculture (USDA). The Petitioner purchases the loans through a broker and is issued a certificate which discloses certain information about the loan. The Petitioner knows the principal balance of the guaranteed portion of the loan, the maturity date, the interest rate, payment information and the office servicing the loan. The Petitioner does not know the identity of the debtor or the financial institution that originated the loan. The loans are guaranteed by the SBA or the USDA, and are backed by the full faith and credit of the United States. If the debtor defaults on the loan, either in whole or in part, the Petitioner is unaware, because regardless of whether the payment originates with the debtor or the SBA, the Petitioner receives the full payment from the agent that administers the loan.

Based on the facts presented, this Office is of the opinion that the Petitioner is not entitled to claim any allowance for these loans. The allowance is for "[o]bligations or securities of the United States, or . . . agency, authority, commission or instrumentality of the United States [or] corporation or entity created under the authority of the United States Congress for the purpose of implementing or furthering an objective of national policy." The evidence in the record does not prove that the loans purchased by the Petitioner are obligations of one of these entities. In fact, it appears that the loans are obligations of individuals. Any obligation of the United States, or agency, authority, commission, instrumentality, corporation or entity described in the statute is

secondary, in that it is simply a guaranty of the loan should the debtor default on the loan. The government's obligation is secondary and contingent. If payments are missed, the government's obligation may be intermittent. This Office is of the opinion that this is not the type of obligation which the Legislature contemplated when it enacted this statute.

It should be noted that there was some discussion in the record respecting the mechanics of what occurred respecting the treatment of these obligations by the Respondent's auditor. The Petitioner apparently did not include these loans when it computed the allowance in filing its returns. At the time of the audit, the Petitioner requested that the auditor include these loans in computing the allowance. The auditor refused, and advised the Petitioner that it would need to file a claim for refund if it believed these loans qualified for the allowance. The Petitioner presented testimony that it filed claims for refund which, at the time of the hearing, had not been allowed or rejected by the Respondent. It was not clear whether or not the Petitioner was entitled to file a petition for refund. Regardless, the Petitioner never filed a petition for refund or amended its petition for reassessment to include a petition for refund. Therefore, this issue is not one that is ripe for decision at this time. As set forth above, even if it were ripe for decision, the petition would be denied.

CONCLUSIONS OF LAW

Based upon all of the above it is **DETERMINED** that:

1. In a hearing before the West Virginia Office of Tax Appeals on a petition for reassessment, the burden of proof is upon the Petitioner to show that any assessment of tax against it is erroneous, unlawful, void or otherwise invalid. *See* W. Va. Code § 11-10A-10(e) [2002]; W. Va. Code. St. R. §§ 121-1-63.1 and 69.2 (Apr. 20, 2003).
2. With respect to the allowances permitted by W. Va. Code §§ 11-23-3(b)(2)(E)(i)(III) [1991] and 11-24-6(f)(1)(C) [1998, 2007], the Petitioner has satisfied its burden of proof by

showing that the loans for which the Petitioner obtained additional collateral are primarily secured by deeds of trust on residential property located in this state and occupied by nontransients.

3. With respect to the allowances permitted by W. Va. Code §§ 11-23-3(b)(2)(E)(i)(III) [1991] and 11-24-6(f)(1)(C) [1998, 2007], the Petitioner has satisfied its burden of proof by showing that the construction loan in question is entitled to the allowance in accordance with Technical Assistance Advisory 93-002, which permits the allowance for “Construction Loans Which Represent A Direct First Lien On Residential Property Located In West Virginia And Occupied By Nontransients.”

4. The Respondent is bound by Technical Assistance Advisory 93-002 until such time as he puts all affected taxpayers on notice by modifying the technical assistance advisory in accordance with W. Va. Code § 11-10-5r [1986], and then only on a prospective basis.

5. The Petitioner’s contention, that it is entitled to a refund because it is entitled to the allowance for SBA and USDA guaranteed loans in its portfolio, is not ripe for decision because the Petitioner has not filed a petition for refund.

6. Even if the Petitioner had filed a proper petition for refund, it would not be entitled to the refund because the SBA and USDA guaranteed loans do not qualify for the allowance permitted by W. Va. Code §§ 11-23-3(b)(2)(E)(i)(I) [1991] and 11-24-6(f)(1)(A) [1998, 2007].

DISPOSITION

WHEREFORE, it is the **FINAL DECISION** of the **WEST VIRGINIA OFFICE OF TAX APPEALS** that the business franchise tax assessment issued against the Petitioner for the period of January 1, 2001, through December 31, 2003, for tax in the amount of \$_____, and interest in the amount of \$_____, computed through May 31, 2004, for a total assessed tax

liability of \$_____, should be and is hereby **VACATED**, and the Petitioner owes no further tax liability for the period in question.

It is **ALSO** the **FINAL DECISION** of the **WEST VIRGINIA OFFICE OF TAX APPEALS** that corporation net income tax assessment issued against the Petitioner for the period of January 1, 2001, through December 31, 2003, for tax in the amount of \$_____, and interest in the amount of \$_____, computed through May 31, 2004, for a total assessed tax liability of \$_____, should be and is hereby **VACATED**, and the Petitioner owes no further tax liability for the period in question.