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NO. 89367-5

SUPREME COURT OF THE STATE OF WASHINGTON

CASHMERE VALLEY BANK,

Petitioner,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

ANSWER TO PETITION FOR REVIEW

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I. INTRODUCTION

This case concerns the taxability of interest income Cashmere Valley Bank earned during 2004-2007 on investments in securities called “collateralized mortgage obligations” or “real estate mortgage investment conduits.” During the tax period, banks and other financial businesses could deduct from the measure of their business & occupation (“B&O”) tax “amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties.” RCW 82.04.4292 (2004). The question addressed is whether the amounts Cashmere received from these investments represented interest received on investments *primarily secured by* first mortgages or trust deeds on residential properties.

Applying the plain meaning of RCW 82.04.4292, the trial court and the Court of Appeals held that the investments were not secured by first mortgages or trust deeds on nontransient residential properties. Consequently, the income did not qualify for the deduction in RCW 82.04.4292 as a matter of law. The Court of Appeals decision affirming summary judgment for the Department was correct, and it does not conflict with any decision of this Court or any prior decision of the Court of Appeals. In addition, because the case does not present an issue of substantial public importance requiring this Court’s determination, the Court of Appeals decision is not a candidate for review under RAP 13.4(b)(4). Accordingly, this Court should deny Cashmere’s petition for review.

II. IDENTITY OF RESPONDENT

Respondent is the State of Washington, Department of Revenue.

III. COUNTERSTATEMENT OF THE ISSUE

During the tax period in this case, RCW 82.04.4292 allowed banks and financial businesses a limited deduction from B&O tax for “amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties.” Did interest income Cashmere received from investments in collateralized mortgage obligations and real estate mortgage investment conduits qualify for this deduction when: (a) the interest paid to Cashmere was owed by bond issuers, not by mortgage borrowers; and (b) the investments were not secured by first mortgages or trust deeds on nontransient residential property?

IV. COUNTERSTATEMENT OF THE CASE

During the years 2004 through 2007, Cashmere held a portfolio of investments that included collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs). CP 15, ¶ 19. The Department audited Cashmere’s B&O tax returns covering those tax periods. CP 489-98. The audit resulted in an assessment of additional B&O tax due on interest Cashmere received from investments in REMICs.¹ CP 489-98. Cashmere paid the assessment and filed an action

¹ Because CMOs and REMICs are indistinguishable for purposes of the issues in this case, the Department will use the terms interchangeably in this brief unless the context indicates otherwise.

for refund under RCW 82.32.180. Cashmere claimed it was entitled to deduct interest on REMICs under RCW 82.04.4292. The trial court denied Cashmere's motion for summary judgment and instead granted summary judgment to the Department. CP 896-98. Cashmere appealed, and the Court of Appeals affirmed the summary judgment. The Court of Appeals held that Cashmere's investments were not primarily secured by mortgages and trust deeds and therefore did not qualify for the deduction because Cashmere had no legal recourse to the mortgages and trust deeds underlying the investments. *Cashmere Valley Bank v. Dep't of Revenue*, 175 Wn. App. 403, 406, 305 P.3d 1123 (2013).

The Court of Appeals began its analysis by summarizing the basic facts and holding in *HomeStreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444, 210 P.3d 297 (2009). In that case, this Court held that HomeStreet could deduct from its taxable gross income under RCW 82.04.4292 amounts it retained when servicing mortgage loans it originated because those amounts were "derived from interest" on otherwise qualifying loans. *Id.* at 455. Applying *HomeStreet*, the Court of Appeals noted that whether amounts were "derived from interest" is not an issue in this case; instead, the controlling question is whether Cashmere's investments in REMICs "were primarily secured by first mortgages or deeds of trust." *Cashmere Valley Bank*, 175 Wn. App. at 409-10. To answer this question required

an understanding of various types of mortgage-backed securities, which the Court provided. *Id.* at 410-13.²

Key to the Court's analysis for purposes of the tax issue here is the distinction between so-called "mortgage pass-through securities" and the more complex REMICs at issue here. As the Court of Appeals concluded, REMICs "remove investor rights in the underlying mortgages." 175 Wn. App. at 412.

The Court's conclusion is consistent with authorities cited in the record. According to Fannie Mae, an investor in a pass-through mortgage-backed security has "an *undivided interest* in a pool of underlying mortgage loans" Fannie Mae Information Statement, CP 761 (emphasis added). Similarly, a federal regulatory body overseeing financial reporting by banks instructs that a pass-through mortgage-backed security represents "an *undivided interest* in a pool that provides the holder with a pro rata share of all principal and interest payments on the residential mortgages in the pool, . . ." Federal Financial Institutions Examination Council (FFIEC) Instructions, CP 339 (emphasis added).

In contrast, the investor in a REMIC does not have an undivided ownership interest in a pool of mortgages or the right to a pro rata share in all principal and interest payments. Instead, REMIC investors have the contractual rights stated in a particular certificate class to specific cash flows from mortgage loans, mortgage pass-through securities, or

² For a more detailed history and overview of mortgage-backed securities, see Brief of Respondent at 3-12 and the authorities and record citations therein.

certificates from other REMICs.³ CP 339; Fannie Mae Information Statement, CP 762.

The Court of Appeals summarized these distinctions as follows:

With mortgage participation certificates and mortgage pass-through securities, the mortgages underlying these securities remain largely intact; any division of interest between parties is accomplished through warranties on or proportionate ownership of those whole loans. In contrast, the mortgages in the pools underlying REMICs and CMOs are divided into the individual principal payments due under each mortgage. The issuer of the REMIC or CMO then reconfigures these payments into new combinations of principal and interest called “tranches.” Each tranche, or class, represents a new security that can be traded separately on the secondary market. . . . *But rather than representing a proportionate ownership in pools of mortgages*, these fractional shares take the form of different classes of bonds issued against and corresponding to the reconfigured mortgage payments that constitute each tranche of the REMIC or CMO.

Cashmere Valley Bank, 175 Wn. App. at 412-13 (footnotes omitted, emphasis added).

The Court of Appeals then turned to the legal issue: whether Cashmere’s investments in REMICs and CMOs were “primarily secured by first mortgages or trust deeds on nontransient residential property.”⁴

The Court started by explaining why the “investments or loans” referred to

³ Cashmere’s expert agreed with these distinctions. Michael Gamsky testified in his deposition that “if you created one class of certificate, then [the cash flows are distributed pro rata]. If you created more than one class, the -- your rights to receive cash flow are whatever you . . . contractually agreed to by buying the certificate.” CP 684.

⁴ Despite Cashmere’s references in briefing to its investments in “pools of mortgages,” it is undisputed that all of the investments at issue in this case were CMOs and REMICs, not mortgage pass-through securities. CP 15 (First Amend. Compl., ¶ 19). *See also* CP 339 (FFIEC’s instructions for reporting various categories of bank-held securities); CP 510, 521 (“DC” column of spreadsheet identifying the “4.b.1.” codes of investments in CMOs and REMICs. A more detailed description of Cashmere’s specific investments is provided in the Brief of Respondent at 12-18.

in RCW 82.04.4292 must be those entered into by the taxpayer—i.e., by Cashmere itself.⁵ 175 Wn. App. at 414-16. The Court concluded that Cashmere could not rely on the nature of the original home loans as “primarily secured” by mortgages or trust deeds and “must show that its investments are themselves ‘primarily secured’ by first mortgages or trust deeds” to take the deduction. *Id.* at 416.

To address whether Cashmere’s investments were secured by mortgages or trust deeds, the Court of Appeals considered the familiar legal meaning of “secured” and “security.” *Id.* at 417. Based on definitions in *Black’s Law Dictionary*, the Court concluded that a “secured” party “necessarily has some recourse to collateral securing its investment.” *Id.*; *see also* CP 685 (expert Michael Gamsky’s testimony that when a promise to pay is “secured by” something else, there is a separate asset outside of the deal that the creditor would own if the debtor failed to fulfill its obligation to pay).

In this case, Cashmere purchased investments in bond instruments that gave Cashmere the right to receive specific cash flows generated by the assets of the trusts at specific times. CP 595; CP 684; CP 761-62. The assets of the REMIC trust were mortgage pass-through securities comprised of pools of loans secured by first mortgages or deeds of trust on residential properties. CP 358, 362; CP 697. However, Cashmere’s investments were *not* secured by those mortgages or deeds of trust.

⁵ Looked at another way, the taxpayer claiming the deduction must be the party whose investment is secured by the mortgage loans or trust deeds.

Instead, the REMIC trustees made an unsecured promise to pay Cashmere in accordance with the terms of the bond class Cashmere purchased. *See, e.g.*, CP 355, 367; CP 704.⁶

As the Court of Appeals noted, Cashmere had no right to proceed against homeowners who failed to make mortgage loan payments and no right to require the REMIC trustees to proceed against homeowners in order to satisfy the trustees' payment obligations to Cashmere. 175 Wn. App. at 417-18; *accord* CP 689-91 (testimony of Michael Gamsky that individual investor in REMIC would have no right to foreclose against defaulting borrower and no say in whether a borrower should be granted a loan modification). Instead, Cashmere's *only* rights as a REMIC investor related to whether *the REMIC trustee* defaulted, in which case a defined proportion of investors in the REMIC could vote to terminate the trustee and retain a successor. CP 729. The Court concluded that Cashmere's REMIC investments were "not secured at all" by the mortgages and trust deeds underlying the investments because Cashmere had no recourse against the real property collateral in the event of default. 175 Wn. App. at 417. Accordingly, Cashmere was not entitled to the deduction in RCW 82.04.4292 for those investments. *Id.* at 418-19.

⁶ In the case of government-sponsored entities, such as Fannie Mae, Fannie Mae guaranteed payment of the agreed principal and interest in the event of a default by mortgage borrowers. CP 355; CP 721. Cashmere's expert Michael Gamsky testified that the existence of a guaranty makes no difference with regard to whether a bond is secured or unsecured. CP 687. Therefore, these guaranties made Cashmere's REMIC investments safer, but they did not render them "primarily secured by first mortgages or trust deeds on nontransient residential properties."

V. REASONS WHY THE COURT SHOULD DENY REVIEW

The Court of Appeals correctly interpreted and applied RCW 82.04.4292 to the undisputed facts in the record.⁷ The decision is perfectly consistent with this Court's decision in *HomeStreet* and the decision of the Court of Appeals in *Department of Revenue v. Security Pacific Bank of Washington N.A.*, 109 Wn. App. 795, 38 P.3d 354 (2002), both of which interpreted and applied RCW 82.04.4292. Cashmere's arguments to the contrary lack merit. In addition, Cashmere's argument that the case is one of substantial public importance requiring this Court's review relies on a misreading of the Court of Appeals decision and is otherwise unconvincing.

A. The Court Of Appeals Decision Does Not Conflict With This Court's Decision in *HomeStreet*.

Cashmere has not presented a basis for this Court to accept review under RAP 13.4(b)(1). The Court of Appeals decision does not conflict with this Court's 2009 decision in *HomeStreet* or any other decision of this Court.

In *HomeStreet*, the taxpayer loaned money to mortgage borrowers to purchase residential properties. *HomeStreet*, 166 Wn.2d at 447. *HomeStreet* sold or securitized 90 percent of the loans. In some instances it sold all its rights in the loans ("servicing released" loans), and in other

⁷ The taxpayer has the burden of proving that it qualifies for a tax deduction and is entitled to a refund. *Washington Imaging Servs., LLC v. Dep't of Revenue*, 171 Wn.2d 548, 555, 252 P.3d 885 (2011); *Cashmere Valley Bank v. Dep't of Revenue*, 175 Wn. App. 403, 408, 305 P.3d 1123 (2013) (citing *HomeStreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444, 455, 210 P.3d 297 (2009)).

instances it retained the right to service the loans and receive a portion of the interest (“servicing retained” loans). *Id.* at 447-48. The issue was whether HomeStreet was entitled to take the deduction in RCW 82.04.4292 for the portion of the borrower interest payments HomeStreet received for servicing the “servicing retained” loans. *Id.* at 448, 451.

With respect to HomeStreet’s servicing retained loans, “borrowers continued to make principal and interest payments to HomeStreet *because HomeStreet still owns a portion of the loan* and services the loans for the secondary market lenders.” *Id.* at 448 (emphasis added). This Court emphasized that ownership connection, explicitly distinguishing the loans HomeStreet sold in their entirety, without retaining servicing rights: “HomeStreet does not maintain any connection with loans sold on a service-released basis.” *Id.*

Analyzing RCW 82.04.4292, this Court identified five required elements of the statute and concluded that only the second element was at issue: whether the amount deducted “was derived from interest received.” *Id.* at 449, 451. The Court concluded that the amounts of interest retained for servicing the retained loans qualified as being “derived from interest” on the loans. In doing so, this Court relied on a direct connection between the mortgage borrowers and HomeStreet:

The revenue at issue here is interest. It is the charge or price borrowers pay HomeStreet for borrowing money from HomeStreet. It is the amount owed to HomeStreet in return for the use of the borrowed money. The amount the borrowers pay to HomeStreet is on existing, valid, and enforceable contracts.

Id. at 453.

Under *HomeStreet*, “interest” is the price paid to borrow money, and it must be paid or received on an “existing, valid, and enforceable obligation.” *Id.* Because HomeStreet “still own[ed] a portion of the loan,” *id.* at 448, 453, this Court held that the source of the interest HomeStreet received was the loan secured by a first mortgage. *Id.* at 454. The Court implied that if HomeStreet had been hired to service loans purchased by a trustee such as Fannie Mae – loans which HomeStreet had not originated – it would not qualify for the deduction. *Id.* at 448.

Here, in contrast to *HomeStreet*, there is no dispute that the mortgage borrowers making the payments that eventually ended up being paid to Cashmere’s REMIC trusts did not borrow money from Cashmere, pay Cashmere, owe Cashmere interest for the use of borrowed money, or have any “existing, valid, and enforceable contracts” with Cashmere. And unlike in *HomeStreet*, Cashmere does not “own” any portion of the mortgage loans underlying the REMIC trust assets. Thus, *HomeStreet* is distinguishable on the facts from this case, and the Court of Appeals decision denying the deduction in this case does not conflict with *HomeStreet*.

Cashmere also argues that the Court of Appeals decision conflicts with *Homestreet* because the Court of Appeals added a sixth element to RCW 82.04.4292, that the taxpayer must have legal recourse to the mortgages and trust deeds underlying a qualified investment. Petition at 8-10. The first flaw in this argument is that it treats this Court’s

description of the requirements for qualifying for the deduction in RCW 82.04.4292 as a legal holding, which then renders any different description of the statutory requirements “conflicting.” The holding in *HomeStreet* was not that RCW 82.04.4292 has five elements (and only five elements). The holding was that HomeStreet could deduct under RCW 82.04.4292 amounts it retained when servicing mortgage loans it originated because those amounts were “derived from interest” on otherwise qualifying loans. *HomeStreet*, 166 Wn.2d at 455.

Rather than constituting a holding, the Court’s breakdown of the statutory elements in *HomeStreet* merely assisted in focusing attention on what was in dispute. In that case it was the second element: whether the amounts were derived from interest. As Cashmere has repeatedly stated in this case, and the Court of Appeals decision affirms, the dispute here centers on the fourth element: whether Cashmere’s investments in REMICs and CMOs were primarily secured by first mortgages or deeds of trust on residential property. Petition at 8; *Cashmere Valley Bank*, 175 Wn. App. at 409-10. The decisions decide different issues and are not in conflict.

Regardless of this Court’s summary in *HomeStreet* of the statutory requirements for taking the deduction in RCW 82.04.4292, Cashmere’s assertion that the Court of Appeals has imposed a new “legal recourse” requirement is incorrect and mischaracterizes the decision. When the Court of Appeals explained that Cashmere had no legal recourse to the mortgages and trust deeds underlying the REMIC assets, it was addressing

a *fact* that supports the *legal conclusion* that Cashmere's REMIC investments were not "primarily secured by" such mortgages and deeds of trust. The Court did not impose any new requirement for qualifying for the deduction in RCW 82.04.4292.

In an argument that goes to the merits, rather than to any conflict with *HomeStreet*, Cashmere also argues that its investments were secured by mortgages and trust deeds because the REMIC trustees had both the right and "the obligation" or "fiduciary duty" to foreclose against defaulting mortgage borrowers. Petition at 10-11. The only authority Cashmere cites for this proposition is a page from the Fannie Mae Information Sheet, which says nothing about any duty or obligation to foreclose:

When a mortgage loan for which Fannie Mae bears the default risk is liquidated through foreclosure, Fannie Mae generally acquires the underlying property (such real estate owned is called "REO") and holds it for sale. The level of delinquencies and number of REO are affected by economic conditions, loss mitigation efforts (which include contacting delinquent buyers to offer a repayment plan, loan modification, preforeclosure sale, or other options), and a variety of other factors.

CP 763. Rather than demonstrate any "obligation" to foreclose on loans in default, this description reveals Fannie Mae's discretion to handle the default by taking into account multiple circumstances. These circumstances could very well include consideration of the nature of the tranches in the REMIC remaining in effect (i.e., not yet paid in full) and

the possible competing interests of those investors.⁸ Cashmere's unsupported arguments about the role of REMIC trustees do not establish that Cashmere's investments were secured by mortgage and trust deeds. The Court of Appeals correctly rejected Cashmere's arguments. 175 Wn. App. at 418.

B. The Court Of Appeals Decision Does Not Conflict With The Decision In *Security Pacific Bank* Or Any Other Court Of Appeals Decision.

Cashmere urges this Court to accept review under RAP 13.4(b)(2), claiming the Court of Appeals decision is in conflict with the decision in *Department of Revenue v. Security Pacific Bank of Washington N.A.*, 109 Wn. App. 795, 38 P.3d 354 (2002). The Court of Appeals did not specifically address *Security Pacific*, although the parties discussed it in briefing. In any event, the Court of Appeals decision upholding summary judgment in favor of the Department is entirely consistent with *Security Pacific*.

Just as in *HomeStreet*, the Court of Appeals decision in *Security Pacific* also turned on what rights the taxpayer claiming the deduction

⁸ Selling the trust assets to the trustee or anyone else would have the same effect as all of the mortgages prepaying at once. See CP 708 (trustee repurchase of loans from underlying pools has the same effect as prepayment). In this situation, the principal-only bondholders would gain, while interest-only bondholders would suffer a loss. See *Glick v. United States*, 96 F. Supp. 2d 850, 863 (S.D. Ind. 2000) (when underlying mortgages are prepaid faster than expected, the future interest rates that an investor was to receive are eliminated, while principal-only investor benefits by receiving payment much faster than anticipated); see also CP 371-72 (prospectus supplement stating that interest-only bondholders could lose money on their investments if prepayments are higher than expected). For bond classes receiving both interest and principal, the effects of a sale of trust assets or unexpected prepayment on underlying loans would depend in part upon whether the bond is a short-term, medium-term, or longer-term bond, and other specific characteristics of the bond class.

actually had in the loans and mortgages. Security Pacific loaned money to mortgage companies under revolving lines of credit to make residential loans. 109 Wn. App. at 798. In return, Security Pacific required the mortgage companies to make full assignment of the residential loans to Security Pacific. *Id.* at 798-99. Security Pacific sold most of these loans on the secondary market. *Id.* at 800.

The central issue in the case was whether the mortgage companies actually transferred ownership of the mortgage loans to Security Pacific, or merely assigned the promissory notes and deeds of trust as collateral for security purposes. The Court of Appeals concluded on the record before it that the assignments transferred ownership of the loans to Security Pacific. *Id.* at 807-08. The assignments therefore placed Security Pacific “in the shoes of the mortgage companies as beneficiaries under the deeds of trust executed by the underlying mortgage borrowers.” *Id.* at 810. Because the assigned mortgage loans were primarily secured by first deeds of trust on nontransient residential property, any interest Security Pacific earned on a mortgage loan from the time of assignment until it sold the loan on the secondary market was deductible under RCW 82.04.4292.

Unlike in *Security Pacific*, Cashmere’s investments in REMICs did not put Cashmere in the shoes of the mortgage companies as beneficiaries under the mortgages or deeds of trust executed by mortgage borrowers. As a REMIC investor, Cashmere had no legal recourse to those mortgages or trust deeds and no ability to dictate to the REMIC trustee what actions should be taken with respect to defaulting mortgage borrowers. *Cashmere*

Valley Bank, 175 Wn. App. at 417-18; accord CP 689-91 (testimony of Michael Gamsky); CP 729 (describing limited right to replace REMIC trustee). These facts preclude Cashmere from qualifying for the deduction in RCW 82.04.4292 and distinguish this case from *Security Pacific*.

Cashmere's arguments for why the Court of Appeals decision is in conflict with *Security Pacific* are confusing. See Petition at 12-15.

Cashmere first disagrees with a footnote addressing the effect of language in a REMIC prospectus indicating that a tranche or class certificate represented a "beneficial ownership interest" in the trust. See 175 Wn. App. at 414 n.10; CP 710. The Court of Appeals correctly explained in that footnote that this prospectus language did not change the fundamental nature of the REMIC investments, which are "essentially interests in bonds (debt), not ownership (equity)." *Id.* The footnote emphasized the Court's point that REMICs cannot be equated to mortgage pass-through securities, where an investment represents a proportionate ownership in pools of mortgages. *Id.* at 413-14. Since the court in *Security Pacific* had no need to address the nature of REMIC investments, footnote 10 in the Court of Appeals decision here does not provide a basis for concluding the decision conflicts with *Security Pacific*.

Cashmere further argues that footnote 10 conflicts with *Security Pacific* because the decision "suggests" that the REMICs were secured by promissory notes, which *Security Pacific* explained do not represent collateral or security. Petition at 12-14; see *Security Pacific*, 109 Wn. App. at 808 ("A promissory note is merely a promise to pay – it is not

security. A deed of trust, however, provides security to back a promise to pay and can be foreclosed after default on the note.”). In the decision below, however, the Court of Appeals gave a very similar description of what represents a secured investment or a security, and nothing in that description conflicts with the statements in *Security Pacific*. See 175 Wn. App. at 417. The Court of Appeals was not confused about the distinction between promissory notes and deeds of trust in either case.

Cashmere also argues that the decision implies that Cashmere “received no real property collateral for the hundreds of millions of dollars invested in the CMO and REMIC securities,” and that this is absurd. Petition at 14. In other words, Cashmere contends this Court should assume that its REMIC investments are primarily secured by mortgages and trust deeds because Cashmere would not risk this much capital without the protection of collateral. What is absurd is Cashmere’s contention. Courts must decide cases based on evidence, not on assumptions. The undisputed facts and evidence in the record do not show any real property collateral offered by the REMIC trustees to back the promises to pay specified interest and principal at specified times to Cashmere.⁹

⁹ On the other hand, believing that “a small community bank” would invest in the REMICs Cashmere invested in is not an “absurdity.” Most of Cashmere’s investments were in REMICs issued by government-sponsored entities such as Fannie Mae, where the trustees guaranteed the payments to investors. See CP 355; CP 721. Accordingly, the trustees, not the REMIC investors, assumed the credit risk of borrower default on the mortgage loans underlying the assets of the REMIC. CP 761. The trustees’ guarantee did not convert the REMICs into investments that are primarily secured by first mortgages or trust deeds.

Finally, Cashmere argues that because CMOs and REMICs are acronyms for names that include the words “mortgage” and “collateralized,” investments in these securities necessarily are secured by mortgages. Petition at 14-15. This argument needs no response. The Department agrees that entitlement to the deduction in RCW 82.04.4292 depends upon whether the investments or loans at issue are secured by mortgages or trust deeds. *See Security Pacific*, 109 Wn. App. at 805. But Cashmere misses the point. The court in *Security Pacific* reviewed the record to decide whether Security Pacific’s loans to mortgage lenders were secured by first mortgages and trust deeds on residential property and concluded that they were, based on how the lenders assigned the mortgage loans and deeds of trust. 109 Wn. App. at 808-10. Here, in contrast, the record shows no transfer of rights in real property to *Cashmere*. As the Court of Appeals correctly concluded, to qualify for the deduction, Cashmere “cannot . . . rely on the nature of the original home loans that underlie its investments” and must instead “show that its investments are themselves ‘primarily secured’ by first mortgages or trust deeds.” 175 Wn. App. at 416. This conclusion is consistent with the plain meaning of the statute and with the decision in *Security Pacific*.

C. The Court of Appeals Decision Does Not Present Issues of Substantial Public Importance That Should Be Determined By This Court.

Contrary to Cashmere’s arguments, this case does not present an issue of substantial public importance to support review under RAP 13.4(b)(4). Cashmere starts with a false premise, that the Court of

Appeals decision deems an otherwise secured investment or loan unsecured when an agent or trustee, rather than the investor or lender, has the authority to foreclose on the collateral. *See* Petition at 15-17.

Cashmere then gives examples of other asset backed securities in which bondholders or investors “have an undivided, collateralized position,” but only the agent or trustee may pursue the collateral. *Id.* According to Cashmere, the Court of Appeals decision potentially will “undermine the credit and investment industries in Washington, since no one will make these kinds of investments if they are deemed unsecured.” Petition at 17.

Nowhere in the Court of Appeals decision is there any statement that a taxpayer must have “direct recourse” or must be able to “directly foreclose” on the collateral in order for an investment to be considered “secured.” What the Court *did* say was that a secured party “necessarily has *some recourse* to collateral securing its investment, and that because Cashmere had “no recourse” to the mortgages and trust deeds underlying the investments, the investments were not secured by those mortgages and trust deeds. 175 Wn. App. at 417 (emphasis added). Cashmere has not offered any legal authority establishing that the Court of Appeals was incorrect.

Contrary to Cashmere’s argument, the Court of Appeals decision does not turn on whether an agent or trustee has the right to foreclosure, rather than the investor. *See* Petition at 10-11, 17. The decision turns, as it should, on the nature of the investments at issue. Cashmere overlooks the fact that its investments in REMICs and CMOs did not represent

“undivided” ownership or collateralized positions, unlike the example it relies on. With respect to the REMICs at issue, it is undisputed that Cashmere had no “undivided” interest in a pool of mortgages.

The Court of Appeals expressly recognized that investors in mortgage pass-through securities have a “proportionate ownership interest” in a pool of mortgages held in trust. 175 Wn. App at 411. The Court also noted that the Department has treated such investments as primarily secured by first mortgages or trust deeds for purposes of RCW 82.04.4292 since 1990. *Id.* at 411-12. The Court had no problem concluding that investments in REMICs and CMOs are different. Rather than having an “undivided” interest in mortgages or trust deeds, a REMIC investor purchases the right to cash flows from “divided” payments from mortgage loans that have been reconfigured into classes or tranches. *Id.* at 412-13. As the Court summarized, “REMICs and CMOs . . . remove investor rights in the underlying mortgages.” *Id.* at 412.

Cashmere also argues that the Court of Appeals decision undermines the Legislature’s purpose to stimulate the residential housing market and to make residential loans to home buyers available at a lower cost. Petition at 17-20. As the Court of Appeals recognized, however, the Department in 1990 published a ruling denying the deduction for CMOs and distinguishing mortgage pass-through securities. 175 Wn. App. at 411-12, 418 (quoting 10 Wash. Tax Dec. 314, Det. No. 90-288 (1990)). Thus, the Court of Appeals decision merely maintains the status quo, rather than constituting a novel approach to the statute. The Legislature

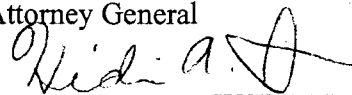
has amended this deduction twice in the last four years to address particular circumstances, but has not addressed REMICs and CMOs in those amendments. *See* Laws of 2012, 2d Spec. Sess. ch. 6, § 102; Laws of 2010, 1st Spec. Sess., ch. 23, § 301. This shows that the Legislature adjusts RCW 82.04.4292 as necessary to conform to its policies and priorities.¹⁰

VI. CONCLUSION

For the foregoing reasons, this Court should deny Cashmere's petition for review.

RESPECTFULLY SUBMITTED this 23^d day of October, 2013.

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State of Washington,
Department of Revenue

¹⁰ Given the role of mortgage derivative securities in the recent recession, it is not safe to assume that the Legislature would choose to extend the deduction in RCW 82.04.4292 to every investment where the cash flow is traceable to residential mortgage loan payments.

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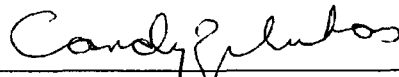
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I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 23 day of October, 2013, at Olympia, WA.



Candy Zilinskas, Legal Assistant

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Cashmere Valley Bank v. State of Washington Department of Revenue
No. 89367-5
Heidi A. Irvin WSBA No. 17500, (360) 753-5528, HeidiI@ATG.WA.GOV