No. 42514-9-II

DIVISION II, COURT OF APPEALS
OF THE STATE OF WASHINGTON

CASHMERE VALLEY BANK,

Plaintiff-Appellant,

v.

STATE OF WASHINGTON,
DEPARTMENT OF REVENUE,

Defendant-Respondent.

ON APPEAL FROM THURSTON COUNTY SUPERIOR COURT
(Hon. Paula Casey)

APPELLANT'S OPENING BRIEF

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ASSIGNMENTS OF ERROR

1. The Thurston County Superior Court (the "trial court") erred in finding that amounts derived by Cashmere Valley Bank as interest on investments in Real Estate Mortgage Investment Conduits and Collateralized Mortgage Obligations (collectively referred to as REMICs) was not entitled to a deduction from the measure of the Washington business and occupation ("B&O") tax under RCW 82.04.4292.[1] Verbatim Report of Proceeding (VRP) at 51-52.

2. The trial court erred in holding that Cashmere Valley Bank had no ownership interest in the underlying loans or the mortgages on the real estate. VRP at 52.

3. The trial court erred in holding that there was no dispute that the REMICs were unsecured investments. VRP at 52.

4. The trial court erred in finding that the REMICs were "by their nature and by their definition unsecured investments." VRP at 52.

5. The trial court erred in holding that the legislature did not intend to grant the deduction to REMICs when the predecessor statute to RCW 82.04.4292 was enacted in 1970. VRP at 53.

6. The trial court erred in entering an order that denied Cashmere Valley Bank's motion for summary judgment. Clerk's Papers (CP) 896-98.

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[1] RCW 82.04.4292 was amended effective June 1, 2010. 2010 1st sp.s. c 23 §§ 301, 1709. Since the tax years at issue in this case are 2004 to 2007 the prior, and not the current, version of RCW 82.04.4292 will be addressed exclusively in this brief.

7. The trial court erred in entering an order that granted summary judgment to the Department of Revenue as the non-moving party. CP 896-98.

8. The trial court erred in entering an order that denied Cashmere Valley Bank's B&O tax refund claim. CP 896-98.

STATEMENT OF THE ISSUE

The following single issue pertains to all of the assignments of error:

1. Deductibility of Interest Income Derived From REMICs. Did the trial court err in holding that Cashmere Valley Bank was not entitled to deduct certain interest income in computing its B&O taxes when: (a) Cashmere Valley Bank is a bank; (b) the income in question consisted of amounts derived from interest; (c) the interest was from investments; (d) the investments consisted of pools of loans secured by first mortgages or trust deeds; and (e) the security on the underlying loans consisted of nontransient residential properties?

I. SUMMARY INTRODUCTION

This appeal asks the Court to determine whether the requirements of a B&O tax deduction statute (RCW 82.04.4292) were satisfied, entitling Plaintiff and Appellant Cashmere Valley Bank to exclude certain interest income from tax.

Cashmere Valley Bank is a community bank headquartered in Cashmere, Chelan County, Washington. During the period at issue in this appeal (2004-2007) Cashmere Valley Bank invested some of its surplus

capital in mortgage securities known as Real Estate Mortgage Investment Conduits (REMICs) and Collateralized Mortgage Obligations (CMOs) (collectively, "REMICs").[2] REMICs are financial instruments that are compilations of individual home mortgages which are bundled and repackaged by third parties (*e.g.*, Fannie Mae, Freddie Mac, Ginnie Mae, and some private entities) into pools, which in turn are sold as securities to investors. A typical REMIC will separate the cash flows of principal and interest payments into what are known as "tranches" (from the French word "tranche," meaning "slice" or "portion"). These tranches – portions – are then sold to institutions like Cashmere Valley Bank and other investors, who receive the designated cash flow of interest and/or principal payments.

In general, the B&O tax is imposed on all forms of business income, but by statute certain income is exempted or may be deducted from the measure of the tax. One such deduction was found in RCW 82.04.4292, which provided:

> In computing [B&O] tax there may be deducted from the measure of tax by those engaged in banking, loan, security or other financial businesses, amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties.

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[2] CMOs and REMICs are essentially the same type of financial vehicle, with REMICs being the more recent phenomena, because they enjoy certain federal tax benefits. CP 124 (Crain Declaration ¶ 7). Both types of investments consist of pools of mortgage loans in which the principal and/or interest payments of the borrowers are passed through to the investors. CP 124-25 (Crain Declaration ¶ 7). A more complete description of REMICs is provided below.

This is not the first time RCW 82.04.4292 has come before this Court. *See HomeStreet, Inc. v. Department of Revenue*, 139 Wn. App. 827, 162 P.3d 458 (2007), *reversed by HomeStreet, Inc. v. Department of Revenue*, 166 Wn.2d 444, 210 P.3d 297 (2009); *Department of Revenue v. Security Pacific Bank of Washington, N.A.*, 109 Wn. App. 795, 38 P.3d 354 (2002). While the facts in the more recent *HomeStreet* decision are somewhat distinguishable from the facts of this case, *HomeStreet* does provide the roadmap for how RCW 82.04.4292 should be applied in this case. There, the Supreme Court observed that the statute contains five elements to qualify income for deduction:

1. The person is engaged in banking, loan, security, or other financial business;
2. The amount deducted is derived from interest received;
3. The amount deducted is received because of a loan or investment;
4. The loan or investment is primarily secured by a first mortgage or deed of trust; and
5. The first mortgage or deed of trust is on nontransient residential real property.

and that "[a]ll five elements of the statute must be met for the taxpayer to receive a deduction." *HomeStreet*, 166 Wn.2d at 449.

This case turns on the fourth requirement, that the investment be primarily secured by a first mortgage or deed of trust. There should be no dispute that the other four elements or requirements of RCW 82.04.4292 were satisfied here. The undisputed facts before the trial court were that Cashmere Valley Bank is a bank that purchased investments known as

REMICs; that REMICs purchase pools of individual home mortgages, which are then bundled into securities; that the REMICs sell interests in these pooled mortgages to investors; that homeowners continue to make payments on their mortgage loans; that these payments of *interest* and principal are passed through from the homeowners to the investors; that Cashmere Valley Bank received interest from its investments in REMICs; that the source of the interest was the homeowners' payments of principal *and interest* on their mortgages; and that the underlying mortgages were primarily secured by first mortgages or deeds of trust on nontransient residential properties. Under these undisputed facts, all of the requirements of RCW 82.04.4292, including the critical fourth element, were satisfied.

The Defendant and Respondent Department of Revenue will presumably argue, as it did to the trial court, that Cashmere Valley Bank was an unsecured investor and therefore did not satisfy the requirements of the statute. But this conclusion conflicts with the plain language and meaning of the deduction statute, which does not say anything about a taxpayer having to be a secured *party* in order to qualify for the deduction. Instead, the statute only requires that the tax deductible "amounts derived from interest received on investments" be "primarily secured by first mortgages or trust deeds on nontransient residential properties." RCW 82.04.4292. That Cashmere Valley Bank received "amounts derived from interest" on REMIC "investments" that were "primarily secured by first mortgages or trust deeds on nontransient residential properties" cannot be

fairly disputed under the plain and unambiguous language of the statute, as interpreted by the Supreme Court in *HomeStreet*. Accordingly, this Court should reverse the trial court, declare that the intended scope of RCW 82.04.4292 allows a deduction to a bank for amounts derived as interest from investments in REMICs that otherwise meet all of the requirements of the statute, and order a full refund of the B&O taxes paid by Cashmere Valley Bank on the disputed interest income.

II. STATEMENT OF THE CASE

A. Overview of the Procedural Record Before the Trial Court.

Three issues were initially raised in Cashmere Valley Bank's complaint to the trial court. CP 3-8. The first issue involved the deductibility of mortgage servicing fees identical to those at issue in *HomeStreet*. CP 3-5. Following the Supreme Court's decision in favor of HomeStreet the parties entered a Notice of Partial Resolution with the trial court, in which the Department conceded this issue and refunded the B&O taxes Cashmere Valley Bank paid on its mortgage service fees. CP 905-906. The two remaining issues were then addressed by the trial court on cross-motions for summary judgment. The first of those two issues – a deduction for interest income derived from investments in SBA Pool Certificates – was decided by the trial court in the Department's favor, CP 299-301, and Cashmere Valley Bank is not appealing that determination. The final issue – a deduction for amounts derived from interest on investments in REMICs – was also decided by the trial court in the

Department's favor (CP 896-898) and is the subject of this appeal (CP 899-902).

B. Cashmere Valley Bank's Business.

Cashmere Valley Bank is a Washington bank established in 1932, and which still maintains its principal place of business in Cashmere, Washington. CP 12 (First Amended Complaint ¶ 1). Cashmere Valley Bank operates branches in several Central Washington cities (Cashmere, Wenatchee, Leavenworth, Ellensburg, Cle Elum, Chelan and Yakima) and it also has a municipal banking office in Bellevue, Washington. CP 13 (Complaint ¶ 4); *see* https://www.cashmerevalleybank.com/history.htm. Cashmere's business includes personal and business banking, mortgage, insurance, investment, leasing and municipal services. *Id.*

C. The Department of Revenue's Audit of Cashmere Valley Bank.

The Department of Revenue audited the books and records of Cashmere Valley Bank for the period January 1, 2004, through December 31, 2007 (sometimes referred to as the "Audit Period"). CP 13 (First Amended Complaint ¶ 5). As a result of the audit, a written report and tax assessment notice were issued to Cashmere Valley Bank by the Department of Revenue. CP 13 (First Amended Complaint ¶ 6; *see* CP 22-32). The audit assessed additional B&O taxes (under the Service classification) on certain unreported or underreported income, totaling $349,726.00 (including interest), during the audit period. CP 22 (Tax

Assessment Number 200918044).[3] The tax assessment was paid in full on June 4, 2009. CP 13 (First Amended Complaint ¶ 7).

D. Cashmere Valley Bank Received Interest on Its Investments in the REMICs, and the Underlying Loans From Which This Interest Was Received Were Primarily Secured by First Mortgages and Trust Deeds on Nontransient Residential Properties.

During all of the years in question (2004-2007) Cashmere Valley Bank maintained a portfolio of investments or an investment account. CP 124 (Crain Declaration ¶ 4). The purpose of the investment account was to optimize earnings within a comprehensive risk management structure, balancing earnings, risk and liquidity. *Id.* Under the Investment Policy (CP 209-225), Cashmere Valley Bank was permitted to invest in certain permissible securities, including the mortgage derivatives known as CMOs and REMICs. CP 124 (Crain Declaration ¶¶ 3, 5).[4] The Investment Policy required any investments in these types of securities to be issued by the U.S. Government or a government-sponsored agency entity, such as Ginnie Mae, Fannie Mae, or Freddie Mac. *Id.* (¶ 4); CP 215-16. The Policy also allowed Cashmere Valley Bank to invest in

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[3] Cashmere made a payment against the assessment on October 24, 2008, in the amount of $3,548.00. CP 22. The net amount of the tax assessment issued on May 12, 2009, was $346,178.00. *Id.*

[4] Cashmere Valley Bank was an *investor* in REMICs. It did *not* make the original loans to the borrowers. It did *not* bundle the loans. It did *not* sell the loans to third parties or perform the securitization of the loans. Cashmere was in the same shoes as pension funds and other investors who *invested* in these financial instruments.

private label mortgage-backed securities (nongovernment agency offerings). *Id.*; *see* CP 216.[5]

Mortgage-backed securities, including CMOs and REMICs, are pools of mortgages in which investors receive an interest in a 30-year payment stream of principal and/or interest from mortgage loans on a pass-through basis. CP 124 (Crain Declaration ¶ 6). REMICs diversify the risk by carving up the cash flows into specific classes (tranches) in which investors receive payments of principal and interest over a shorter period of time, *e.g.*, five years, 10 years, or 15 years, instead of 30 years, which is the typical term or payment period of a mortgage. *Id.* Cashmere Valley Bank rarely, if ever, invested in the full 30-year streams of payment. *Id.* [6]

Cashmere Valley Bank purchased REMICs for its investment portfolio primarily from Fannie Mae and Freddie Mac. CP 125 (Crain Declaration ¶ 8). Cashmere Valley Bank also purchased interests in

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[5] Under the Investment Policy Cashmere Valley Bank was permitted only to invest in highly rated CMOs and REMICs. In other words, Cashmere's management was not allowed to invest in risky investments like REMICs that contained subprime loans. The Investment Policy included certain broad "Investment Portfolio Objectives." CP 209. Included within these objectives are "Capital Protection." Here, the policy states, "Funds will be invested only into securities which are deemed to be of sufficient quality and maturity that will not expose the Bank to unnecessary risk of principal." *Id.* The Investment Policy also has an absolute prohibition against holding securities for trading: "**No investments are to be purchased with the intent to be traded.**" CP 211 (bold emphasis in original). This is a further indication of the conservative nature of the Cashmere Valley Bank's investments.

[6] There are actually numerous types of mortgage pools created by the various agencies, including pools that contain 15-year, 30-year, or adjustable rate mortgages. Pools can also consist of not only single-family residential mortgages, but multi-family residential mortgages, as well. As noted, Cashmere Valley Bank's investments consisted of pools that contained 30-year fixed-rate mortgages on single-family residences. CP 124.

mortgage pools from private banks like the former Washington Mutual. *Id.* In all cases, the underlying loans that made up the REMICs at issue in this case were primarily secured by first mortgages or deeds of trust on nontransient residential real properties. *Id.*[7]

E. How a REMIC Is Created and Operates.

Cashmere Valley Bank retained three expert witnesses for trial. One of the expert witnesses, Alan C. Hess, Ph.D. (*see* CP 235-242),[8] prepared a paper or report for this litigation titled "An Economic Analysis of the Dispute." CP 227-233.[9] In a section of the report titled "A brief

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[7] The record contains numerous instances of this fact. Cashmere Valley Bank's former Chief Financial Officer, Alan Crain, stated: "The underlying loans in the various REMICs in which Cashmere invested were primarily secured by first mortgages or deeds of trust on nontransient residential real properties." CP 125 (Crain Declaration § 8). This testimony was not disputed or rebutted by the Department of Revenue. The record also includes REMICs representative of the REMICs in which Cashmere Valley Bank invested during the audit period. One of those was Fannie Mae REMIC Trust 2000-38. CP 355-379. The Prospectus Supplement of this REMIC stated: "The mortgage loans underlying the Fannie Mae MBS and the Ginnie Mae certificates are first lien, single family, fixed-rate loans." CP 355. Another Fannie Mae Single-Family REMIC Prospectus is in the record at CP 697-753. This prospectus likewise states: "The assets of the trust will include certain underlying securities typically issued and guaranteed by us or by Ginnie Mae. These underlying securities represent the ownership of pools of residential mortgage loans secured by single-family properties." CP 697.

[8] The other two experts were Michael J. Gamsky, Esq., and Chirag G. Shah. *See* CP 244, CP 255-58.

[9] Dr. Hess is a Professor of Finance and Business Economics and the Robert L. Stephenson Endowed Professor at the University of Washington, Foster School of Business. *See* CP 235-242. He has been at the University of Washington since 1967 and his specialties include banking, financial markets, interest rates, and risk management. *Id.* In 1988, Dr. Hess, along with Professor Clifford W. Smith, currently the Louise and Henry Epstein Professor of Business Administration and Professor of Finance and Economics at the University of Rochester, wrote "Elements of Mortgage Securitization" published in the *Journal of Real Estate Finance and Economics* (1988), and later reprinted in *Studies in Financial Institutions: Commercial Banks* (1994). CP 236.

primer on REMICs and CMOs" Dr. Hess explained how REMICs are created and operate:

> REMICs and CMOs are securities that are compilations of individual home mortgages in which lenders such as [Cashmere Valley] Bank advance money to home buyers in return for each home buyer's promise to repay the loan principal plus interest over a specified number of future dates. At least since Adam Smith, economists have noted that specialization in production reduces costs and generates benefits for society. REMICs and CMOs came into being when financial intermediaries recognized that the costs of intermediation could be reduced by separating loan origination, loan servicing, and ownership of the loan's cash flow rights into three separate functions. Financial institutions such as [Cashmere Valley] Bank originate mortgages and often sell them to FNMA [Fannie Mae] and FHLMC [Freddie Mac] who repackage the cash flows into REMICs and CMOs.
>
> The repackaging consists of four steps: First, the REMIC-generating intermediary, such as Lehman Brothers, buys a large number, say 1000, of mortgages whose payments are guaranteed by FNMA or FHLMC. Second, the intermediary separates each payment by a home owner into its principal and interest components. For example, if a home owner has a 30-year fixed rate mortgage that requires monthly principal and interest payments, the intermediary would separate the 360 monthly payments into 360 principal payments and 360 interest payments for a total of 720 separate payments. If there are 1000 mortgages in the pool, the pool has 720,000 separate payments of principal and interest. Third, the intermediary constructs a small number, say six, of new securities by dividing the various payments from the 720,000 payments flowing into six new combinations of principal and interest. These new combinations are often called tranches, a French word for slice, which we may think of as portions of the mortgage pool. Fourth, the intermediary sells fractional shares of each of the tranches to financial institutions such as [Cashmere Valley] Bank, and to other investors who want to hold securities with the projected cash flow patterns of the various tranches of the REMIC or CMO.

> In short: home owners make monthly payments of principal and interest that go into a mortgage pool; an intermediary recombines the separate principal and interest payments into new securities called REMIC tranches; third, the intermediary sells units of each tranche to investors. On a fixed-interest rate REMIC, such as those bought by [Cashmere Valley] Bank, the amount of interest paid by homeowners into the mortgage pool equals the amount of interest received by REMIC investors net a portion of the costs to the intermediary of constructing and marketing the REMIC. [Footnote omitted.]

CP 227-29 (bracketed inclusions added).

Dr. Hess's explanation of how REMICs are created and operate is consistent with how others describe such investments. For example, the global investment firm PIMCO described mortgage-backed securities as follows:

> 1. A mortgage lender, such as a bank, extends a loan to a homeowner.
>
> 2. The mortgage lender then sells the loan to a government-sponsored enterprise (GSE), such as Fannie Mae or Freddie Mac (. . . also called "Agencies"), or to a private entity, like a bank or finance company. The lender may still service the mortgage, making this process invisible to the homeowner.
>
> 3. The Agency or private entity then takes a number of the mortgage loans it has purchased and bundles them together into a "pool." The actual number of individual mortgages in the pool can vary from a few loans to thousands of loans. As homeowners make their monthly payments, the pool of mortgages generates a regular cash flow.
>
> 4. The Agency or private entity then sells claims on that cash flow, in the form of securities (bonds), to investors. After the initial sale, MBS [mortgage-backed securities] trade on the open market.

> 5. Mortgage payments, consisting of interest and principal, are passed through the chain, from the mortgage service to the bondholder.

CP 277-78 (citing *Mortgage-Backed Securities* (Feb. 2009) (http://www.pimco.com/Pages/MortgageBackedSecurities.aspx)) (bracketed inclusion added). The government agency Freddie Mac, a primary issuer, also described how mortgage-backed securities operate, as follows:

> Lenders originate mortgages and provide groups of similar loans to organizations like Freddie Mac and Fannie Mae, which then securitize them. Originators use the cash they receive to provide additional mortgages in their communities. The resulting MBSs carry a guarantee of timely payment of principal and interest to the investor and are further backed by the mortgaged properties themselves. Ginnie Mae securities are backed by the full faith and credit of the U.S. Government. Some private institutions issue MBSs, known as "private-label" mortgage securities in contrast to "agency" mortgage securities issued and/or guaranteed by Ginnie Mae, Freddie Mac or Fannie Mae. Investors tend to favor agency MBSs because of their stronger guarantees, better liquidity and more favorable capital treatment. . . .
>
> The agency MBS issuer or servicer collects monthly payments from homeowners and "passes through" the principal and interest to investors. Thus, these pools are known as mortgage pass-throughs or participation certificates (PCs). Most MBSs are backed by 30-year fixed-rate mortgages, but they can also be backed by shorter-term fixed-rate mortgages or adjustable rate mortgages.

CP 278 (citing Kelman, A., *Mortgage-backed Securities & Collateralized Mortgage Obligations: Prudent CRA INVESTMENT Opportunities* (March 2002)).

F. Cashmere Valley Bank's Refund Claim and the Procedural History of This Case.

As previously indicated, the Department of Revenue audited Cashmere Valley Bank for the period January 1, 2004, through December 31, 2007, which was documented in an audit report dated May 12, 2009. CP 22-33. A net tax assessment in the net amount of $346,178.00 was issued by the Department on the same date. CP 22-23; *see* n.3, *supra*. Cashmere Valley Bank paid the assessment in full on June 4, 2009. CP 4.

On July 22, 2009, Cashmere Valley Bank filed a complaint in Thurston County Superior Court (CP 3-11), alleging it overpaid its B&O taxes under three specific audit areas or revenue sources: (1) mortgage service fees; (2) SBA Pools; and (3) REMICs and CMOs (CP 5). Shortly before Cashmere Valley Bank filed its complaint the Supreme Court decided *HomeStreet* (166 Wn.2d 444) on June 18, 2009. Subsequently, the Department of Revenue agreed to refund the B&O taxes Cashmere Valley Bank paid on mortgage service fees, since the fees at issue in the Cashmere Valley Bank audit were identical to the mortgage service fees at issue and decided in *HomeStreet*. A Notice of Partial Resolution was thereafter filed with the trial court on July 30, 2010. CP 905-906. On February 18, 2011, Cashmere Valley Bank filed a first amended complaint with the trial court. CP 12-17. The amended complaint no longer contained the refund request for mortgage service fees but asserted additional claims with respect to the remaining two issues (SBA Pools, REMICs and CMOs). *Id.*

On May 27, 2011, the Department of Revenue filed a motion for partial summary judgment on the SBA Pool issue. CP 105-122. Cashmere Valley Bank responded on June 28, 2011, opposing the Department's motion and requesting summary judgment on both the SBA Pool issue and the REMIC and CMO issue. CP 259-279. Thereafter, the parties entered into a Stipulated Order Regarding Summary Judgment Orders. CP 280-82. Under this order the parties agreed to bifurcate the remaining two SBA Pool and REMIC and CMO issues for purposes of summary judgment. *Id.* Cashmere Valley Bank's opposition to the Department of Revenue's motion for partial summary judgment on the SBA Pool issue was treated as Cashmere's motion for partial summary judgment on the REMIC issue. CP 281. The SBA Pool issue was to be heard by the trial court on July 8, 2011, and the REMIC and CMO issue on July 22, 2011. CP 282.

The summary judgment hearings were held as scheduled. On July 8, 2011, the Honorable Paula Casey ruled in favor of the Department of Revenue on the SBA Pool issue and entered partial summary judgment to the Department. CP 299-301. Cashmere Valley Bank has not appealed this ruling. On July 22, 2011, Judge Casey heard the REMIC issue and again ruled for the Department of Revenue (*see* VRP 50-53), holding that Cashmere Valley Bank was not entitled to deduct the interest it received from investments in REMICs because:

> What Cashmere purchased was a contractual agreement to receive a return on its investment. Cashmere [Valley] Bank had no ownership interest in the underlying loans or the mortgages on the real estate. In fact, it is clear and no one disputes that the REMICs

> themselves are unsecured investments. Accordingly, I find that they are not entitled to a deduction under RCW 82.04.429(2) [*sic*].

VRP at 51-52. Judge Casey also held, speaking to the Legislature's original enactment of the statute (1970 c 101 1st ex. sess. § 2), that:

> . . . the 1970 Legislature did not have REMICs in mind, did not intend that there be this type of investment that was allowed to have a deduction from the B&O tax . . . .

VRP 53.[10]

An Order Denying Cashmere Valley Bank's Motion for Summary Judgment and Granting Summary Judgment to the Department of Revenue was entered at the conclusion of the hearing. CP 896-98. The July 22, 2011 order stated that, "This Order disposes of the last remaining claim in this case." CP 897. Cashmere Valley Bank then filed a Notice of Appeal to this Court on August 22, 2011. CP 899-902.

III. STANDARD OF REVIEW

The trial court decided the REMIC issue based on a motion for summary judgment brought by Cashmere Valley Bank. CP 896-98. "Summary judgment is reviewed *de novo*." *American Best Food, Inc. v. Alea London, Ltd.*, 168 Wn.2d 398, 404, 229 P.3d 693 (2010) (citing *Liberty Mut. Ins. Co. v. Tripp*, 144 Wn.2d 1, 10, 25 P.3d 997 (2001)). The issue presented in this case is the interpretation of RCW 82.04.4292, and statutory interpretation is a question of law, also reviewed *de novo*.

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[10] The notion that the Legislature only intends a tax or a deduction from tax to apply to goods or, as in this case, investment activity known to it at the time of the enactment of the tax or deduction, is without merit. For example, the 1935 Legislature could not have had Apple iPhones, iPads, and iPods in mind when it originally enacted the retail sales tax, but this tax unquestionably applies to purchases and sales of these items in 2012.

HomeStreet, 166 Wn.2d at 451 (citing *City of Seattle v. Burlington N. R.R.*, 145 Wn.2d 661, 665, 41 P.3d 1169 (2002)).

IV. ARGUMENT

A. The Plain Meaning of RCW 82.04.4292, as Established by the Supreme Court's Decision in *HomeStreet v. Department of Revenue*, Compels the Conclusion That "Amounts Derived From Interest" Received on Investments in REMICs Are Deductible From the Measure of the B&O Tax.

The issue in this case involves statutory interpretation and the application of the "plain meaning" rule. "The primary objective of any statutory construction inquiry is 'to ascertain and carry out the intent of the Legislature.'" *HomeStreet,* 166 Wn.2d at 451 (quoting *Rozner v. City of Bellevue*, 116 Wn.2d 342, 347, 804 P.2d 24 (1991)). The starting point is the language of the statute. *State v. Armendariz*, 160 Wn.2d 106, 110, 156 P.3d 201 (2007). If that language lends itself to only one interpretation, the Court's inquiry ends because plain language does not require construction. *Id.* Thus, where a statute is unambiguous, courts must give words their plain meaning and presume that legislative intent has been clearly expressed. *Burton v. Lehman*, 153 Wn.2d 416, 422, 103 P.3d 1230 (2005). The Supreme Court has already determined that RCW 82.04.4292 "is unambiguous and subject only to one interpretation," *HomeStreet*, 166 Wn.2d at 454, and under that interpretation Cashmere Valley Bank is entitled to the deduction at issue.

1. RCW 82.04.4292 Contains Five Elements, Each of Which Must Be Present Before "Amounts Derived From Interest" May Be Deducted.

The question before the Court is whether Cashmere Valley Bank may deduct the interest it received from its investments in REMICs. The statutory deduction stated in its entirety is as follows:

> In computing tax there may be deducted from the measure of tax by those engaged in banking, loan, security or other financial businesses, *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 (emphasis added). As the Supreme Court stated:

> RCW 82.04.4292 contains five elements:
>
> 1. The person is engaged in banking, loan, security, or other financial business;
> 2. The amount deducted was derived from interest received;
> 3. The amount deducted was received because of a loan or investment;
> 4. The loan or investment is primarily secured by a first mortgage or deed of trust; and
> 5. The first mortgage or deed of trust is on nontransient residential real property.
>
> . . . All five elements of the statute must be met for the taxpayer to receive a deduction.

HomeStreet, 166 Wn.2d at 449.

Thus, a plain reading of the language of the statute outlines the five elements that must be present for a taxpayer to deduct "amounts derived from interest on investments."

2. Cashmere Valley Bank Satisfied Each and Every Element of RCW 82.04.4292; the Supreme Court's Decision in *HomeStreet v. Department of Revenue* Provides the Roadmap for the Resolution of This Case.

There is no question that elements one through three were satisfied here. First, Cashmere Valley Bank is a person that engages in a banking, loan, security or other financial business.[11] Second, the amounts derived were from interest received. Mortgage derivative securities like REMICs pass through to their investors payments of principal *and interest* made by borrowers. CP 229, 277-78. The record reflects that what was received from the REMICs was interest. CP 145-48. Even the Department of Revenue's audit report acknowledged that REMICs "direct principal *and interest* payments" to investors. CP 492 (emphasis added). Third, the amount deducted must be because of an investment or loan. (While *HomeStreet* dealt with loans, this case is about investments.) The Investment Policy of Cashmere Valley Bank allowed for investments in REMICs. CP 124 (Crain Declaration ¶¶ 5, 6). The first three requirements of the statute were clearly met here.

Nor is the fifth element in dispute, which requires that the underlying mortgages or deeds of trust be secured by nontransient residential real properties. There should be no dispute that the REMICs at issue in this case consisted of pools of mortgages, that each individual

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[11] RCW 82.04.030 defines a "person" to include, among others, a firm, joint venture, company, corporation, limited liability company, association, or "any group of individuals acting as a unit, whether mutual, cooperative, fraternal, nonprofit, or otherwise . . . ." Cashmere Valley Bank was established as a Washington bank in 1932. CP 3.

mortgage was secured by a first mortgage or deed of trust on nontransient residential property, and even the trial court recognized that the underlying loans were mortgages secured by nontransient residential properties. VRP at 51 ("There is no question that what ultimately generates the income to fund the REMICs is [sic] home mortgages that are purchased by investors"); *see* fn.7, *supra* (citing to relevant portions of the record establishing that the loans were so secured).

That leaves the fourth element, requiring that the *investment* be primarily secured by first mortgages or deeds of trust. If the REMIC investments made by Cashmere Valley Bank were primarily secured by first mortgages or deeds of trusts, Cashmere Valley Bank would have satisfied all five elements and would be entitled to deduct "amounts derived from interest" from the measure of its B&O tax.

Prior to addressing the fourth requirement of RCW 82.04.4292, it is important to understand the full context of the decision in *HomeStreet.* The issue presented was whether amounts derived by HomeStreet from loan servicing were deductible from the measure of its B&O taxes. HomeStreet originated mortgage loans and sold about 90 percent of those loans to secondary market lenders, primarily Fannie Mae, Freddie Mac, and Ginnie Mae. *HomeStreet*, 166 Wn.2d at 447-48. In some cases HomeStreet sold only a portion of the loans, and retained the right to service the loans and receive a portion of the interest as its compensation. *Id.* at 448. On these "servicing retained" loans, borrowers made payments of principal and interest, HomeStreet collected the payments from the

borrowers, paid the investors the principal and a portion of the interest, and retained a portion of the interest as its servicing fee. *Id.*[12] HomeStreet received a portion of the interest only if borrowers made the interest payment on their loans.[13] The issues addressed in *HomeStreet* were: (1) What does the term "amounts derived from interest" (RCW 82.04.4292) mean? (2) Did the fee HomeStreet received from servicing the loans qualify for the deduction because the income represented "amounts derived from interest"? *HomeStreet*, 166 Wn.2d at 451.

In answering these questions, the Supreme Court first addressed the meaning of "interest" and whether what HomeStreet received was, in fact, interest. *HomeStreet*, 166 Wn.2d at 452. The Supreme Court relied on decisions of the state and federal courts, and dictionaries (*Black's* and *Webster's*) to ascertain the plain meaning of the word interest.[14] The Supreme Court then concluded:

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[12] Had Cashmere Valley Bank's REMIC investments been in loans originated by HomeStreet, Cashmere Valley Bank would have been one of the investors who received a portion of the interest paid by the borrower and which passed through HomeStreet, and that payment would have been reduced by the amount of HomeStreet's servicing fee.

[13] This is in contrast with the interest received by the *investors* in government-sponsored REMICs, *i.e.*, those underwritten by Fannie Mae, Freddie Mac and Ginnie Mae, where payments of principal and interest were *guaranteed* to be made to the investors by the agency. Still, what investors received was a guaranteed payment of principal and *interest*.

[14] The court held, relying on the common and ordinary meaning of the word "interest," as follows:

> The term "interest" is not defined in RCW 82.04.4292 or in any tax statute in chapter 82.04 RCW but has been defined in several cases. "Interest is merely a charge for the use or forbearance of money." *Security Sav. Soc'y v. Spokane County*, 111 Wash. 35, 37, 189 P. 260 (1920). "[F]or an amount to constitute interest, it must be paid or received on an existing, valid, and enforceable obligation." *Thompson v. Comm'r*, 73 T.C. 878, 887-88 (1980) (citing *Meilink v.*

(Footnote is continued on next page.)

> 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. The amount of money HomeStreet receives is not set but rather changes with the size and length of the loans, interest rate fluctuations, and the borrowers' ability to pay back the loan.

HomeStreet, 166 Wn.2d at 453.

Here, as in *HomeStreet*, the "amounts derived" consisted of interest. The interest was paid by the borrowers and passed along to Cashmere Valley Bank. This point was conceded by the Department of Revenue in its audit of Cashmere Valley Bank, which noted REMICs "direct principal *and interest* payments" to investors. CP 492 (emphasis added). Likewise, there should be no question that this interest income represented the charge or price borrowers (homeowners) paid for borrowing the money to purchase the residential property. In a REMIC, the loan servicer collects the payments of principal and interest from the borrowers. These amounts are then passed along in the chain and ultimately paid to the investors, with the loan servicer retaining a portion of the interest payment as a servicing fee. The question in *HomeStreet*

> *Unemployment Reserves Comm'n*, 314 U .S. 564, 570, 62 S. Ct. 389, 86 L. Ed. 458 (1942)).
>
> "Interest" is defined as "[t]he compensation fixed by agreement or allowed by law for the use or detention of money, or for the loss of money by one who is entitled to its use; esp., the amount owed to a lender in return for the use of borrowed money." BLACK'S LAW DICTIONARY 829 at para. 3. (8th ed. 1999). "Interest" is also defined as "the price paid for borrowing money generally expressed as a percentage of the amount borrowed paid in one year." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1178 (2002).

HomeStreet, 166 Wn.2d at 452-53.

was whether the loan servicing fee was deductible as "amounts derived from interest." The court answered affirmatively and held that these amounts were deductible under RCW 82.04.4292. These facts are confirmed in *HomeStreet* (166 Wn.2d at 448). This case is about the deductibility of the *remaining* portion of the homeowner's interest payment, after the servicing agent has taken out its fee and which is paid to investors like Cashmere Valley Bank.

REMICs are structured and operate to receive mortgage payments, consisting of interest and principal, which are passed through from the borrower to the mortgage servicer, and finally, to the bondholder or investor. As in *HomeStreet*, here the amounts the borrowers (homeowners) paid under their mortgages were pursuant to existing, valid, and enforceable contracts, and those contracts were secured by single family residential mortgages or deeds of trust. While the amount of interest an investor such as Cashmere Valley Bank receives may change with the payment, given the size and length of the loan, interest rate fluctuations (if the underlying loans were variable rate loans, rather than fixed), the point in the loan period at which the payment was made, and the borrowers' ability to pay back the loan, the "amounts derived" by the investor are still unquestionably "derived from" interest.[15]

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[15] Government-sponsored REMICs, such as those issued by Fannie Mae or Freddie Mac, paid interest and principal even if the loan payment was not made by the borrower because the payment was guaranteed.

This was the final – and critical – question addressed in *HomeStreet*: What does the phrase "derived from" mean, in RCW 82.04.4292? The Supreme Court resolved this question by again relying on the common and ordinary dictionary definition, as follows:

> "Derived from" is not defined in the B&O tax statutes either. "Derived" is defined as "to take or receive esp. from a source." WEBSTER'S, *supra*, at 608. The Court of Appeals states the revenue at issue "is, in the broadest sense, 'derived from interest' because HomeStreet deducts it directly from the interest stream the loans generate." *HomeStreet*, 139 Wn. App. at 843. The State's expert witness, Earl Baldwin, said the income is "'derivative' of mortgage interest because the fee is deducted from the interest portion of the loan as provided by the agency-seller contract." CP at 748.
>
> The revenue at issue here is received from a source, and the source is interest. The revenue is therefore "derived from interest" because it is taken from the interest the borrowers pay on their loans. When DOR argues the revenue is taken from the interest by HomeStreet as a servicing fee, it goes too far. Under the statute it is not essential to determine why the money is received or taken from a source. *See* RCW 82.04.4292. The statute requires only that the amount be "*derived* from interest." RCW 82.04.4292 (emphasis added). The statute does not say the amount must not be used for a servicing fee either. The plain meaning of the statute allows deductions for amounts received from interest, and HomeStreet qualifies for this deduction because it receives interest from the loans.

HomeStreet, 166 Wn.2d at 453-54.

Given this holding, there should be no question that the portion of income Cashmere Valley Bank received from its investments in REMICs, and which is at issue in this proceeding, was "derived from" interest. The authorities are clear: the "amounts derived" by investors in REMICs consist of the interest stream *directly from the loans*. "Mortgage

payments, consisting of interest and principal, are passed through the chain, from the mortgage servicer to the bondholder [investor]." CP 278 (citing *Mortgage-Backed Securities* (Feb. 2009) (http://www.pimco.com/Pages/MortgageBackedSecurities.aspx)) (bracket inclusion added). "The agency MBS issuer or servicer collects monthly payments from homeowners and 'passes through' the principal and interest to investors." CP 278 (citing Kelman, A., *Mortgage-backed Securities & Collateralized Mortgage Obligations: Prudent CRA INVESTMENT Opportunities* (March 2002)). As Dr. Alan Hess stated in his (unrebutted) report:

> . . . [H]ome owners make monthly payments of principal and interest that go into a mortgage pool; an intermediary recombines the separate principal and interest payments into new securities called REMIC tranches; [and], the intermediary sells units of each tranche to investors. On a fixed-interest rate REMIC, such as those bought by [Cashmere Valley] Bank, the amount of interest paid by homeowners into the mortgage pool equals the amount of interest received by REMIC investors net a portion of the costs to the intermediary of constructing and marketing the REMIC.

CP 227-29 (bracketed inclusions added).

In short, there should be no question that Cashmere Valley Bank received "amounts derived from interest" on its "investments" in REMICs. The Department of Revenue nonetheless argued to the trial court that Cashmere Valley Bank was not entitled to the deduction because it did not have a direct relationship with the borrowers making the interest payments, under which the borrowers had a contractual obligation to pay Cashmere Valley Bank:

> The borrowers making the payments that eventually end up in Cashmere's REMIC investments *do not* pay Cashmere. Nor do they borrow money *from* Cashmere. The borrowers *do not owe* Cashmere for the use of borrowed money, and they do not have any "existing, valid, and enforceable contracts" with Cashmere.

CP 316-17 (emphasis in original) (quoting *HomeStreet*). In other words, the Department of Revenue is effectively arguing that Cashmere is not entitled to the deduction because it did not have the rights of a lender. But the only way Cashmere Valley Bank could have those rights would be if Cashmere made the underlying loans, or received an assignment of those loans.

Cashmere Valley Bank was not lending money; instead, it is an *investor* and the REMICs are Cashmere's *investments.* By requiring Cashmere to have the rights of a lender, the Department of Revenue is collapsing "investments or loans" in RCW 82.04.4292 into just "loans" and effectively reading the word "investments" out of the statute. Yet, as the Supreme Court stated in *HomeStreet*:

> "[E]ach word of a statute is to be accorded meaning." *State ex rel. Schillberg v. Barnett*, 79 Wn.2d 578, 584, 488 P.2d 255 (1971). Whenever possible, statutes are to be construed so " 'no clause, sentence or word shall be superfluous, void, or insignificant.' " *Kasper v. City of Edmonds*, 69 Wn.2d 799, 804, 420 P.2d 346 (1966) (quoting Groves v. Meyers, 35 Wn.2d 403, 407, 213 P.2d 483 (1950)).

166 Wn.2d at 452.[16]

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[16] At the July 8, 2011 summary judgment hearing, the court asked the Department of Revenue's counsel to clarify what an investment secured by real estate might be. The following colloquy occurred:

> THE COURT: ... Mr. Zalesky, ... I do have a question at the outset. I just wanted you to clarify what an investment secured by real estate would be.

(Footnote is continued on next page.)

There is nothing in the text of RCW 82.04.4292, when it addresses *investments*, which says borrowers must pay Cashmere directly; that requires Cashmere to loan money directly to the borrowers; that requires,

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> MR. ZALESKY: An investment - - okay. So you'd have to think of it as the mortgage - - there's sort of the - -
>
> THE COURT: Income from that, yes.
>
> MR. ZALESKY: Right. So in sort of the mortgage industry there's the primary mortgage, which is the lender lends money to the borrower, and there's a mortgage. There's also the secondary mortgage market where the borrower sells that mortgage to an investor. That investor is not the one that actually made the loan. They're an investor in the sense that they're buying that mortgage.
>
> So that would be a circumstance where an investment could be secured by residential real property because that investor, Cashmere Valley Bank or whoever, is buying that loan. So that's how the language can be construed.

VRP at 21-22.

The problem with this "construction," of course, is it flies in the face of the ordinary meaning of "investment," and therefore *still* effectively writes this concept out of the statute. An assignee of a loan is *not* an investor; an assignee steps into the shoes of the original lender and becomes the substitute lender. "An assignee of a contract 'steps into the shoes of the assignor, and has all of the rights of the assignor.'" *Puget Sound National Bank v. Dep't of Revenue*, 123 Wn.2d 282, 292, 868 P.2d 127 (1994) (quoting *Estate of Jordan v. Hartford Accident & Indem. Co.*, 120 Wn.2d 490, 495, 844 P.2d 403 (1993)). On the other hand, an investor is one who puts "(money) into business, real estate, stocks, bonds, etc. for the purpose of obtaining an income or profit." *Webster's New World Dictionary Third College Edition* (1994) at 710. An example of an investment secured by real estate is a REMIC. This is clear from one of the Fannie Mae REMIC documents in the record. The prospectus states:

> In general, each underlying security will represent a fractional undivided interest in a pool of first lien residential mortgage loans.

CP 702. The prospectus goes on:

> Each series trust will consist of (i) underlying securities which represent (directly or indirectly) all or part of the beneficial *ownership* in pools of *single-family residential mortgage loans generally in first-lien position* and (ii) the trust account, including all cash and investments in the trust account (the "Trust Account").

CP 710 (emphasis added). Thus, a REMIC is an example of an investment. A loan that has been assigned is still a loan and is not converted into an investment just because it has been assigned by the originator of that loan to a third party.

as a condition to the deduction, the borrowers to owe money directly to Cashmere; or that requires the borrowers to have a direct contractual relationship with Cashmere. In fact, these requirements do not exist in the plain language of the statute, and courts "cannot add words or clauses to an unambiguous statute when legislature has chosen not to include that language." *State v. Delgado*, 148 Wn.2d 723, 727, 63 P.3d 792 (2003). Cashmere Valley Bank is receiving "amounts derived from interest on *investments*" (RCW 82.04.4292 (emphasis added)), not amounts derived from interest on loans, and amounts derived from interest on investments is all that the statute required.

In *HomeStreet* the Department argued that HomeStreet was receiving a servicing fee, not interest. The Supreme Court rejected this claim, holding that the Department had gone "too far," and that under the statute (RCW 82.04.4292) it was "not essential to determine why the money is received" because the statute only required that the amount be "derived from interest." *HomeStreet*, 166 Wn.2d at 454. Similarly, the Department of Revenue goes too far here, when it reads into the statute requirements that, for the B&O tax deduction to apply, the recipient of the interest must receive the interest payments directly from the borrowers, make the loans to the borrowers, and have a contractual relationship with the borrowers such that the borrowers owe the interest directly to the investors. The statute contains no such requirements; instead, it only required that the *investment* that generated the interest payment *itself* be *primarily secured* by first mortgages or trust deeds. That the underlying

loans in the REMICs in which Cashmere Valley Bank invested met this requirement is beyond genuine dispute. In fact, even the trial court found that the underlying loans were first mortgages and that the mortgages were secured. VRP 51. The trial court went wrong when it adopted the Department of Revenue's argument that Cashmere Valley Bank "had no ownership interest in the underlying loans or the mortgages on the real estate." VRP 52. As argued, ownership of the underlying loans is not a requirement for deduction under RCW 82.04.4292. To adopt such a holding would obliterate the "amounts derived from interest *on investments*" (emphasis added) language of the statute and be a mischaracterization of the evidence.

In short, the plain meaning of RCW 82.04.4292 allows a deduction for amounts derived from interest received on investments, so long as the recipient of the interest is a bank or other financial business and the investments *themselves* are primarily secured by first mortgages or deeds of trust on nontransient residential properties. The Department's argument that the fourth element of RCW 82.04.4292 was not met and that Cashmere Valley Bank presented no "evidence that its REMIC investments are secured by first mortgages or deeds of trust on residential properties" (CP 320) is a misreading of the statute and a mischaracterization of the evidence. Cashmere Valley Bank qualifies for the deduction because it has met the applicable provisions of the clear and unambiguous language of RCW 82.04.4292, as interpreted by the Supreme Court in *HomeStreet*.

B. The Department of Revenue's Arguments Over the Requirements of the Interest Deduction Were Not Only Rejected in *HomeStreet*, but Were Rejected in the Prior *Security Pacific Bank* Decision, as Well.

The Department of Revenue's argument boils down to an attempt to have this Court say that only the original mortgage lender may take the deduction. This was the Department's argument under *HomeStreet* and why the Department insists that only the secured party is entitled to claim the deduction. Yet this argument was rejected not only in *HomeStreet* but in *Department of Revenue v. Security Pacific Bank*, 109 Wn. App. 795, as well.

Security Pacific Bank loaned money to mortgage companies. 109 Wn. App. at 798. The mortgage companies, in turn, used the monetary advances from Security Pacific to fund loans to third-party borrowers. *Id.* These loans were all "primarily secured by first lien deeds of trust on various types of nontransient residential properties." *Id.* All of the loans in question were also pre-assigned to Security Pacific upon closing. *Id.* at 798. In most cases, Security Pacific subsequently sold the loan into the secondary market. *Id.* at 799.[17]

Each assigned loan from the mortgage companies remained in Security Pacific's portfolio until its sale on the secondary market. 109 Wn. App. at 800. While Security Pacific owned the loans the Department of Revenue denied the bank an interest deduction under RCW 82.04.4292.

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[17] The facts in *Security Pacific* do not state to whom the loans were sold in the secondary market, but it is safe to say that many of the loans were likely sold to Fannie Mae, Freddie Mac, and Ginnie Mae.

Id. Interestingly, the Department *granted* the RCW 82.04.4292 deduction to the secondary market investors because the latter obtained beneficial ownership of the loans after purchasing them. *Id.* (citing 8 WTD 241, 245 (1989)).[18] The Department of Revenue denied the deduction to Security Pacific because the Department contended that the "mortgage companies were the true owners of the loans and that Security [Pacific Bank] only acquired a personal property security interest via the assignments." *Id.* at 801.

This Court rejected these (and other) arguments of the Department, holding that the RCW 82.04.4292 deduction "covers loans primarily secured by trust deeds on nontransient residential properties." *Id.* at 804. It follows that the deduction also covers *investments* "primarily secured by first mortgages or trust deeds on nontransient residential properties," RCW 82.04.4292; *Security Pacific*, 109 Wn. App. at 804, which is exactly what is at issue here. *Security Pacific* and *HomeStreet* clearly show that the party entitled to the mortgage interest "revenue" or "amounts derived from interest" is entitled to the deduction, regardless whether that party is the lender, the purchaser of the loan, the servicer, or the investor receiving the interest on a pass-through basis. The Supreme Court's rulings in *Security Pacific* and *HomeStreet* acknowledge that every portion of the qualifying interest is deductible. By eliminating REMIC interest from the deduction,

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[18] 8 WTD 241 is a published Department of Revenue determination that is deemed precedential. *See* RCW 82.32.410. The secondary market mortgage investors, in turn, sell the cash flow rights in the loans to investors like Cashmere Valley Bank.

the Department does two things. First, it reads the word "investments" out of the statute. *See* argument on page 26, *supra*. Second, the Department would make interest on loans in a REMIC investment by a bank like Cashmere nondeductible. This would drive up the cost of mortgage loans that are sold in the secondary markets through REMICs and be contrary to the legislative intent at the time the deduction was enacted to make home mortgages affordable. *See*, *Security Pacific*, 109 Wn. App. at 804.

This Court also rejected the Department's argument that Security Pacific is not entitled to the deduction because "every advance Security made to the mortgage companies was 'short-term' or that the mortgage companies sold each loan they originated within days" (*id.* at 805), holding instead that:

> . . . the deduction does not depend on whether the advances it made were short-term or whether the mortgage companies sold the loans they originated within days. Instead, the deduction depends on whether the loans were secured by trust deeds on nontransient residential properties.

Id.

In the context of this case, the deduction likewise does not depend on whether the ultimate investor in the pooled loans through the REMIC actually "owns" the loan (certainly, the investor owns the cash flow rights (CP 228)) nor does it depend on whether the investor is the "secured party" as the Department seems to contend; instead, entitlement to "the deduction depends on whether the [investments] were secured by trust deeds on nontransient residential properties." *Id.* at 805. These requirements were satisfied here.

In *Security Pacific* the Department of Revenue also argued that "when a mortgage company defaulted, Security [Pacific] did not foreclose against the real property, but instead it sold the mortgage loans on the secondary market." *Id* at 809. This Court found this argument "unpersuasive." *Id.* The Department makes the same contention in this case, arguing that Cashmere Valley Bank does not have a valid and enforceable contract. CP 317. This argument is equally unpersuasive because it is nothing more than a different way of saying that Cashmere Valley Bank, like Security Pacific Bank, did not have the right to foreclose on the loan.

This Court in *Security Pacific* went to great length to emphasize that the RCW 82.04.4292 "deduction covers *loans* primarily secured by trust deeds on nontransient residential properties" (*id.* at 804), not who happens to be the secured party. As this Court stated:

> The purpose of RCW 82.04.4292 "was to stimulate the residential housing market by making residential loans available to home buyers at lower cost through the vehicle of a B&O tax [deduction] on interest income received by home mortgage lenders." CP at 33. Under the plain language of the statute, [footnote omitted] the deduction created by RCW 82.04.4292 is available to any bank if its loan is "primarily secured by first mortgages or trust deeds on nontransient residential properties." RCW 82.04.4292.

Id.

In Security Pacific's case, the bank was advancing funds to undercapitalized mortgage companies so that the latter could extend mortgage loans. 109 Wn. App. at 798. This stimulated the housing market because it allowed companies, who otherwise lacked sufficient

working capital, to obtain that capital from banks, like Security Pacific, to finance the home mortgage origination activities of the mortgage companies. *Id.* Security Pacific's loans to the mortgage companies, under revolving lines of credit (*id.*), certainly helped "to stimulate the residential housing market by making residential loans available to home buyers." *Id.*

Cashmere Valley Bank stands in similar shoes to Security Pacific Bank. Cashmere purchased interests in various REMICs, which are pools of loans secured by first mortgages or trust deeds on nontransient residential properties. The secondary market lenders (like Fannie Mae and Freddie Mac) take the money invested by investors such as Cashmere Valley Bank and purchase new pools of residential loans. Once the loans are sold in the secondary market by the original lenders, the "[o]riginators use the cash they receive to provide additional mortgages in their communities." CP 278 (citing Kelman, A., *Mortgage-backed Securities & Collateralized Mortgage Obligations: Prudent CRA INVESTMENT Opportunities* (March 2002)). This point is made in the record from none other than Fannie Mae itself:

> Fannie Mae provides funds to the mortgage market by purchasing mortgage loans from lenders, *thereby replenishing their funds for addition lending.* Fannie Mae acquires funds to purchase these loans by issuing debt securities to capital market investors, many of whom ordinarily would not invest in mortgages. In this manner, *Fannie Mae is able to expand the total amount of funds available for housing.*
>
> Fannie Mae also issues Mortgage-Backed Securities ("MBS"), receiving guaranty fees for its guarantee of timely payment of principal and interest on MBS certificates. Fannie Mae issues

> MBS primarily in exchange for pools of mortgage loans from lenders. The issuance of MBS enables Fannie Mae to further its statutory purpose of *increasing the liquidity of residential mortgage loans.*

CP 757 (emphasis added).

In short, this continuous cycle of money flowing from investors to the pools and from the home buyers into the pool (via the latter's payments of principal and interest) create the same type of stimulus to the residential housing market because it makes "residential loans available to home buyers at lower cost through the vehicle of a B&O tax [deduction] on interest income received by home mortgage lenders." *Security Pacific*, 109 Wn. App. at 804.

Cashmere Valley Bank is itself a home mortgage lender. CP 13; *see* https://www.cashmerevalleybank.com/history.htm. It makes loans to home buyers but also participates in the home lending process by investing in REMICs, which hold loans secured by first mortgages or trust deeds on nontransient residential properties (RCW 82.04.4292). As this Court said, the plain language of this statute creates a deduction for *any bank* if the loan is primarily secured with a first mortgage or trust deed on a nontransient residential property. *Security Pacific*, 109 Wn. App. at 804. Cashmere Valley Bank's receipt of interest from investments in REMICs satisfies each and every requirement of the plain and unambiguous language of RCW 82.04.4292, as well as the legislative invent in enacting this B&O tax deduction.

Finally, the Department of Revenue places much emphasis on the fact that Cashmere Valley Bank does not itself have the right to foreclose

on the loan if the home owner defaults in making the payments. CP 321. Why should it matter if the right to foreclose is exercised by the trustee, instead of by Cashmere Valley Bank or any of the other investors or beneficiaries? The fact remains that there *is* a right to foreclose, and the trustee has a fiduciary duty to exercise that power to protect the interests of the investors as beneficiaries of the interest payments. Nothing in the language of RCW 82.04.4292 supports the Department of Revenue's insistence that the investor must be able to exercise the right of foreclosure directly, rather than be able to rely upon a trustee to exercise it (knowing that the trustee is bound by a fiduciary duty to exercise that right to protect the investor's interests).

The Department of Revenue's approach also violates the rule of construction that every word of a statute must be given meaning, because the Department's approach effectively eliminates the distinction drawn by the statute between loans and investments; stated differently, the Department's approach collapses investments into loans by insisting that investments have the same characteristics as loans. *See* argument at 26, *supra*.

Ultimately, the Department of Revenue's approach frustrates the admitted purpose of the statute, which by its terms was to allow banks to take a deduction for interest earned *either* on *investments* or loans, so long as they are secured by first mortgages or deeds of trust, and thereby reducing the transaction costs related to the mortgages themselves. CMOs and REMICS are innovative forms of financial instruments which allow

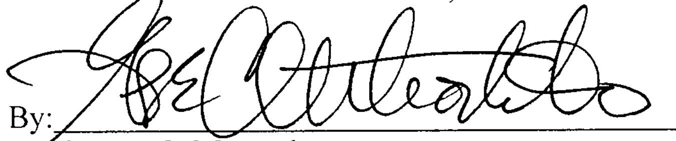
the bundling of mortgages into pools, to the ultimate benefit of consumers. Denying investors like Cashmere Valley Bank the benefit of the deduction for interest income earned by investing in CMOs and REMICS would reduce the pool of investors interested in making such investments, to the ultimate detriment of consumers. That is precisely the kind of increased transaction cost that the deduction was intended to avoid.

V. CONCLUSION

This Court should rule that the plain language of RCW 82.04.4292 entitled Cashmere Valley Bank to a B&O tax deduction for amounts derived as interest from investments in REMICs. This Court should reverse the trial court, and order a refund of the B&O taxes Cashmere Valley Bank overpaid to the Department of Revenue.

RESPECTFULLY SUBMITTED this 23rd day of February, 2012.

CARNEY BADLEY SPELLMAN, P.S.



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COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION TWO

Cashmere Valley Bank, Appellant, vs. State of Washington Department of Revenue, Respondent.	DECLARATION OF SERVICE

I certify that on the date set forth below I served a copy of the following: *Appellant's Opening Brief along with a copy of the Verbatim Report of Proceedings for the July 8, 2011 and July 22, 2011 motion hearings* and *Declaration of Service* upon the following attorneys of record:

Heidi A. Irvin Charles Zalesky Brett Durbin Assistant Attorneys General Revenue Division P.O. Box 40123 Olympia, WA 98504-0123 HeidiI@ATG.WA.GOV ChuckZ@ATG.WA.GOV BrettD@ATG.WA.GOV	X U.S. Mail, postage prepaid

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

DATED this 23rd day of February, 2012, at Seattle, Washington.

PATTI SAIDEN, Legal Assistant