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STATE OF WASHINGTON

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COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

**HOMESTREET, INC., HOMESTREET CAPITAL
CORPORATION, and HOMESTREET BANK,**

Appellants,

v.

**STATE OF WASHINGTON, DEPARTMENT OF
REVENUE,**

Respondent.

BRIEF OF APPELLANTS

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I. Assignments of Error

1. The trial court erred by creating a requirement that exceeds the plain language of the business and occupation ("B&O") tax deduction statute, RCW 82.04.4292: that a residential mortgage lender "hold" notes to qualify for the deduction.

2. The trial court erred by denying HomeStreet the B&O tax deduction under RCW 82.04.4292 despite the uncontroverted fact that the amounts at issue were derived from interest and, therefore, satisfied the plain language of the statute.

II. Statement of Issues

1. Whether the plain language of RCW 82.04.4292 requires that a taxpayer "hold" notes in order to qualify for the B&O tax deduction? (Assignment of Error 1.)

2. Whether amounts that are undisputedly "derived from interest" and retained by HomeStreet from borrowers' payments of interest on residential first mortgages that HomeStreet originated and either securitized or sold in part on the secondary market are deductible under RCW 82.04.4292? (Assignment of Error 2.)

III. Statement of the Case

A. HomeStreet's Residential Mortgage Lending Business

HomeStreet, Inc. (formerly known as Continental, Inc.) is the parent corporation of HomeStreet Bank (formerly known as Continental Savings Bank) and HomeStreet Capital Corporation (formerly Continental Mortgage Company, Inc.) (collectively, "HomeStreet"). CP 144 (Warhol Aff. ¶ 4). All three entities are engaged in the residential mortgage lending business. CP 144 (Warhol Aff. ¶ 7).

HomeStreet originates thousands of residential mortgage loans each year. CP 159 (Johnson Aff. ¶ 5). Like most residential mortgage lenders, HomeStreet sells or securitizes some or all of the rights associated with most of the loans it originates.¹ CP 160 (Johnson Aff. ¶ 13). These secondary market transactions allow HomeStreet and other lenders to make more residential loans by freeing up capital that is otherwise entirely invested in a relatively small number of loans and by spreading the risk among a larger number of loans. CP 160 (Johnson Aff. ¶ 18).

HomeStreet sells loans or parts of loans on the secondary market in two ways. First, HomeStreet sells loans directly to investors, often referred to as a "whole loan" transaction. CP 197 (Byers Aff. ¶ 7).

HomeStreet sells whole loans to secondary market investors either (a) in their entirety (referred to as "servicing released") or (b) while retaining the right to receive a portion of the interest (referred to in the industry as "servicing retained"). CP 197 (Byers Aff. ¶¶ 8 and 9). Sales of loans on a servicing released basis yield higher prices than loans sold with an interest retained because the later is a transfer of less than the entire loan asset. CP 48 (Baldwin Dep. Transcript at 129); CP 233 (Byers Dep. Transcript at 29); CP 197 (Byers Aff. ¶¶ 7-9); CP 160 (Johnson Aff. ¶¶ 13, 14).² Second, HomeStreet sells securities to investors that are backed by the mortgages or deeds of trust of HomeStreet originated loans and guaranteed by a guaranty agency such as the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), or the Government National Mortgage Association ("Ginnie Mae"). CP 197 (Byers Aff. ¶ 10). The vast majority of HomeStreet's secondary market transactions at issue in this case involve sales of mortgage-backed securities guaranteed by Fannie Mae to secondary

¹ About 10% of the loans that HomeStreet originates are retained in their entirety. CP 160 (Johnson Aff. ¶ 12).

² This case does not involve the taxation of loans sold on a servicing released basis.

market investors or sales of loans to Fannie Mae with an interest retained by HomeStreet.³ CP 199 (Byers Aff. ¶ 20).

In both securitization transactions and sales of loans with a retained interest, mortgage borrowers continue to make payments of principal and interest to HomeStreet over the course of their loans. CP 161 (Johnson Aff. ¶ 20). Mortgage borrowers are generally unaware that a secondary market transaction has occurred because it has no impact on how borrowers interact with HomeStreet in connection with the repayment of their loans. CP 161 (Johnson Aff. ¶ 21). HomeStreet processes borrower payments and administers the loan in the same manner that it administers loans that it retains in their entirety in HomeStreet's portfolio. CP 161 (Johnson Aff. ¶ 21).

On a monthly basis, HomeStreet remits the scheduled principal and a portion of the interest to secondary market investors. CP 198 (Byers Aff. ¶ 13); CP 161 (Johnson Aff. ¶ 20). HomeStreet must timely make these payments to secondary market investors whether or not the borrower

³ With respect to the retained interest at issue in this case, HomeStreet engaged in a smaller number of secondary market transactions with Ginnie Mae, the Federal Home Loan Bank of Seattle, the State of Oregon, Freddie Mac, Mellon Mortgage, Bank of America, Interwest Savings, CUNA Mutual, and Home Capital Collateral. CP 198-199 (Byers Aff. ¶¶ 17 – 19).

timely makes his or her loan payment. CP 149. In addition, HomeStreet pays Fannie Mae or another guaranty organization a "guaranty fee" for guarantying the payments to the secondary market investors. CP 198 (Byers Aff. ¶ 14); CP 160-161 (Johnson Aff. ¶¶ 16, 20).

HomeStreet's receipt of its retained interest revenue is contingent on the borrower's continued payment of interest. CP 162 (Johnson Aff. ¶ 24). If a borrower fails to make a loan payment, HomeStreet does not receive payment or any compensation from the secondary market investor or the guaranty agency. CP 509 (Fannie Mae Servicing Guide, Part I, § 203.01); CP 616 (Ginnie Mae MBS Guide, Ch. 6).

B. The Past Tax Treatment of HomeStreet and Other Residential Mortgage Lenders

Prior to 1970, financial institutions were generally not subject to B&O tax. CP 762. In 1970, the Legislature extended the B&O tax to financial institutions, but kept a deduction for "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties." 1970 Wash. Laws, Ch. 65, § 5 (creating the residential mortgage deduction); 1970 Wash. Laws, Ex. Sess., Ch. 101, § 2 (repealing the B&O tax exemption for financial institutions). The Legislature adopted the deduction notwithstanding the DOR's objections that the deduction would

be too expensive (in the sense of forgoing potential new tax revenue) and was not necessary to accomplish the Legislature's goal of protecting residential mortgage lending. CP 789-791 (DOR's Memorandum to Senator Mike McCormick, dated February 2, 1970). Shortly after receiving the DOR's memorandum, Senator McCormick promptly moved to suspend the rules, and the Senate passed the bill without amendment. CP 767. The Legislature's purpose in enacting the deduction and retaining the nontaxability of amounts derived from residential mortgage interest 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." *Washington State Dept. of Revenue v. Security Pacific Bank of Washington*, 109 Wn.App. 795, 804, 38 P.3d 354 (2002).

Until 1999, the DOR agreed with HomeStreet and other residential mortgage lenders that amounts retained by lenders from borrowers' payments of interest on residential first mortgages that were securitized or sold in part on the secondary market were deductible under RCW 82.04.4292. HomeStreet received a formal DOR determination confirming this treatment in 1992. CP 147-157 (DOR Det. No. 92-403). The DOR issued similar to determinations to other residential mortgage lenders. *See, e.g.*, CP 58-73 (DOR Det. No. 92-392, 12 WTD 535), CP

114-130 (DOR Det. No. 92-404), CP 132-142 (DOR Det. No. 94-158). The DOR choose to publish and designate one such determination as binding departmental precedent pursuant to RCW 82.32.410. CP 13 (Mahon Aff. ¶ 5), CP 58-73 (DOR Det. No. 92-392, 12 WTD 535).

The current dispute stems from the DOR's decision in 1999 to reverse its position and impose tax on residential mortgage lenders' retained interest, although there had been no change to the controlling statute. To support its new position, the DOR asserted that the B&O tax deduction would be limited to "the owner of the loan or investment" or "the person who retains the risk of interest rate fluctuations." CP 13 (Mahon Aff. ¶ 6), CP 106 (DOR Det. No. 98-218, 18 WTD 46 (1999) at 58). Following its reversal of policy, the DOR audited HomeStreet, assessed B&O tax on HomeStreet's retained interest for the period 1997 through 2001, and issued reporting instructions requiring HomeStreet to begin paying B&O tax on such amounts. CP 144-145 (Warhol Aff. ¶ 10). In December 2002, the DOR and HomeStreet entered into a closing agreement that settled the assessment and specifically contemplated that HomeStreet could dispute the retained interest issue for subsequent periods. CP 145 (Warhol Aff. ¶ 11).

Consistent with the closing agreement, HomeStreet reported and paid \$20,224.72 in B&O tax with respect to retained interest received

during the month of January 2003 on loans primarily secured by first mortgages or deeds of trust on nontransient residential property. CP 145 (Warhol Aff. ¶ 12). HomeStreet promptly filed suit for refund in Thurston County Superior Court on March 10, 2003 to resolve the legal issue. CP 4-8.

C. Trial Court Proceedings

After extensive discovery, the trial court heard HomeStreet's motion for summary judgment on January 13, 2006. CP 836. In its oral ruling from the bench following argument, the court noted that, "Thinking back on my own thought process during the course of this case, I have changed my opinion several times as new pleadings came in and even during the course of the argument this afternoon" RP 50. "Speaking bluntly," the judge continued, "part of me would like to spend the next three weeks writing the quintessential opinion on the subject ..., but I also recognize that there is a Court in Tacoma that will probably have the last word on this, if anyone chooses to present it to them." *Id.*

The trial court went on to deny HomeStreet's motion by creating a new requirement outside the statute, declaring, "the deduction goes to the holder of the note, and once HomeStreet no longer holds the note, they are

no longer entitled to the deduction."⁴ RP 52. The trial court did not cite any authority in the statutory language or otherwise to support its new requirement. Rather the court merely opined that its new requirement was "probably consistent with the underlying legislative purpose at the time of the statute." RP 53.

The trial court subsequently issued an order granting summary judgment to the DOR "for the reasons stated in the Court's oral ruling on January 13, 2006." CP 837.

IV. Summary of Argument

The plain language of RCW 82.04.4292 does not require that HomeStreet "hold" notes in order to qualify for the B&O tax deduction, it only requires that the deductible amounts be "derived from interest." Neither the DOR nor the trial court has authority to add a requirement to RCW 82.04.4292.

The B&O tax deduction statute requires that HomeStreet establish that its receipts were "derived from interest." Prior DOR determinations held that HomeStreet's retained interest revenue was not just derived from

⁴ Neither HomeStreet nor the DOR had presented any argument or discussion regarding who "holds" the notes related to securitized loans or loans sold with an interest retained. Nor did the trial court make any attempt to establish the criteria by which an originating lender would no longer be considered the "holder" of the note or its loans.

interest, but construed to be "interest." HomeStreet is entitled to the deduction whether its revenue is "interest" or "amounts derived from interest." The undisputed record demonstrates that amounts retained by HomeStreet from borrowers' payments of interest on residential first mortgages that HomeStreet originated and either securitized or sold in part on the secondary market are "derived from interest" and deductible under RCW 82.04.4292. This result is consistent with both the plain language of the statute and the Legislature's purpose of stimulating the residential housing market by reducing the cost of home mortgage lending.

Finally, even under the DOR's current practice restricting the deduction to "the owner of the loan or investment" or "the person [who] retains the risk of interest rate fluctuation," HomeStreet is entitled to the deduction because HomeStreet retains a valuable portion of the loan asset and risk of interest rate fluctuation. CP 106 (DOR Det. No. 98-218, 18 WTD 46, 58 (1999)), CP 48-49 (Baldwin Dep. Transcript at 128-131).

V. Argument

A. **RCW 82.04.4292 Does Not Require that Residential Mortgage Lenders "Hold" Notes to Qualify for the B&O tax Deduction.**

The trial court denied HomeStreet's deduction under RCW 82.04.4292 by asserting, "the deduction goes to the holder of the note, and once HomeStreet no longer holds the note, they are no longer entitled to

the deduction." RP 52. However, there is no statutory requirement that a mortgage lender hold notes. RCW 82.04.4292 provides:

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.

One of the most fundamental principles of statutory construction is that courts "should not and do not construe an unambiguous statute." *Vita Food Products, Inc. v. State*, 71 Wn.2d 132, 134, 587 P.2d 535 (1978). Thus, the Supreme Court has repeatedly held that "plain language does not require construction." *State v. Wilson*, 125 Wn.2d 212, 217, 883 P.2d 320 (1994). To the same effect, courts "cannot add words or clauses to an unambiguous statute when the legislature has chosen not to include that language." *State v. Delgado*, 148 Wn.2d 723, 727, 63 P.3d 792 (2003). Yet that is exactly what the trial court did when it created a new requirement that the deduction be limited to "holders" of notes.

There is no authority, statutory or otherwise, for the DOR or the trial court to add requirements or conditions to RCW 82.04.4292. Washington courts have previously rejected attempts to add requirements or conditions for tax exemptions that are not contained in the statute. *Lone Star Industries, Inc. v. Department of Revenue*, 97 Wn.2d 630, 647 P.2d

1013 (1982); *Van Dyk v. Department of Revenue*, 41 Wn.App. 71, 702 P.2d 472 (1985). In *Lone Star*, the Washington Supreme Court held that the DOR's attempt to impose a "primary purpose test" as an additional requirement for the "ingredient" exemption from sales tax was invalid:

RCW 82.04.050 does not require that the tangible personal property so purchased be acquired primarily for the purpose of such consumption in order to avoid taxation as a "retail sale." ... In short, in determining the applicability of the tax, there is no "primary purpose test" required for property that becomes an ingredient or component of the new article.

Lone Star, 97 Wn.2d at 634-35.

Because HomeStreet's revenue at issue is "derived from interest," HomeStreet is entitled to the deduction under RCW 82.04.4292. The trial court erred in denying HomeStreet its deduction based on a requirement not contained in the statute.

B. HomeStreet's Retained Interest Is "Derived from Interest" and, Therefore, Deductible under RCW 82.04.4292.

The issue in this case is whether amounts retained by HomeStreet from borrowers' payments of interest on residential first mortgages that HomeStreet originated and either securitized or sold in the secondary market with a retained interest are amounts "derived from interest" under RCW 82.04.4292. Statutory interpretation is a question of law that is

reviewed de novo. *Agrilink Foods, Inc. v. Department of Revenue*, Wn.2d 392, 396, 103 P.3d 1226 (2005).

The DOR asserts that, contrary to the plain language of the statute, the Legislature intended to limit the deduction "only to interest," thereby treating the statutory words "amounts derived from interest" as mere surplusage.⁵ RP 28-29; CP 761, 763, 769. Despite acknowledging that HomeStreet "is still receiving something that looks like an interest stream," the trial court denied HomeStreet's deduction because it allegedly did not "hold" the notes. RP 52. The DOR's argument and the trial court's ruling are contrary to the plain language of RCW 82.04.4292, the Legislature's purpose in enacting the deduction, and the DOR's own current precedential determination on the issue.

1. HomeStreet Is Entitled to the Deduction under the Plain Language of the Statute.

The cornerstone of statutory interpretation is that legislative intent is derived from the plain language of the statute. "Where statutory language is plain and unambiguous courts will not construe the statute but will glean the legislative intent from the words of the statute itself, regardless of contrary interpretation by an administrative agency."

Agrilink Foods, 153 Wn.2d at 396. Only when statutory language is ambiguous (*i.e.*, subject to more than one reasonable construction) may a court resort to extrinsic aides, such as legislative history. *State v. Roggenkamp*, 153 Wn.2d 614, 621, 106 P.3d 196 (2005). Here, the plain language of the statute is unambiguous. Neither HomeStreet nor the DOR have presented competing constructions of the meaning of the statutory phrase "amounts derived from interest."

Instead, the DOR and the trial court read the statutory words "amounts derived from" out of the statute and replace them with "only" interest. In oral argument on HomeStreet's summary judgment motion, the DOR's counsel was quite frank:

THE COURT: So what is the purpose of the "derived from" language?

MR. COFER: The purpose is basically meaningless. There is no purpose.

THE COURT: So, essentially, those terms are surplusage?

MR. COFER: The language is roundabout or awkward ... They could have just said, "The

⁵ Before the trial court, the DOR made no attempt to justify or explain the change from its prior position when the DOR recognized the type of revenue at issue in this case to be interest.

following sources of income will not be taxable under this chapter."

RP 28-28. While the candor is commendable, courts are required to give effect to all of the language used by the Legislature, and may not rewrite or delete language from an unambiguous statute. *Roggenkamp*, 153 Wn.2d at 632; *State v. Azpitarte*, 140 Wn.2d 414, 142, 995 P.2d 31 (2000) (reversing Court of Appeals' decision that failed to give effect to statutory term).

The plain meaning of "derived" is "received from a specified source." Black's Law Dictionary 444 (6th ed. 1990). *See also, e.g.*, Webster's Third New International Dictionary 608 (1981) (defining "derive" as "to take or receive esp. from a source."); American Heritage College Dictionary 375 (3rd ed. 1997) (defining "derive" as "to obtain or receive from a source."). There is no dispute that the revenue at issue is "paid from interest" and is "embedded as a part of it." The DOR's own expert witness testified that HomeStreet's retained interest (servicing) assets are derivatives that are paid from interest on the underlying mortgage loan:

Q. Is servicing asset essentially a type of derivative?

A. Yes.

Q. Is the [servicing] asset a form of strip?

A. No.

Q. It doesn't strip a portion of the interest payment off the original mortgage loan?

A. It is paid from interest. It's embedded as a part of it.

CP 50 (Baldwin Dep. Transcript at 136 – 137) (emphasis added).

The record is uncontroverted that borrowers are required to make payments of interest and principal to HomeStreet. CP 161 (Johnson Aff. ¶ 20). HomeStreet processes those payments and makes payments of principal and a portion of the interest to secondary market investors. CP 198 (Byers Aff. ¶ 13); CP 161 (Johnson Aff. ¶ 20). HomeStreet's receipt of its retained interest revenue is contingent on the borrower's continued payment of interest.⁶ CP 162 (Johnson Aff. ¶ 24). HomeStreet's agreements with Fannie Mae and Ginnie Mae explicitly provide that HomeStreet is *not* entitled to receive revenue from any source other than the borrower's payment of interest. CP 509 (Fannie Mae Servicing Guide, Part I, § 203.01), CP 616 (Ginnie Mae MBS Guide, Ch. 6) (describing the

⁶ The guaranty fee that HomeStreet pays to Fannie Mae or other guaranty agencies guaranties that the secondary market investors will be paid, but does *not* guaranty that HomeStreet will continue to receive its retained interest revenue. CP 198 (Byers Aff. ¶ 14); CP 160-161 (Johnson Aff. ¶¶ 16, 20).

"servicing fee" as "*based on and payable only from the interest portion of each monthly installment of principal and interest actually collected by the issuer on the mortgage.*") If a borrower fails to make a loan payment, HomeStreet does not receive any revenue from Fannie Mae, Ginnie Mae, or anyone else. *Id.*

Under the plain language of the statute, HomeStreet does not need to establish that its receipts were "interest" (although the DOR's prior determinations hold that HomeStreet's revenue was interest), only that its receipts were "derived from interest." As described above, the record is undisputed that HomeStreet's receipts are derived from interest.

2. HomeStreet's Deduction Is Consistent with the Legislative Purpose of RCW 82.04.4292.

In addition to violating the plain language of the statute, the DOR's interpretation of the deduction undermines the Legislature's purpose in enacting the deduction. As this Court described in *Security Pacific Bank*, 109 Wn.App. at 804, the Legislature's purpose 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." Congress had a similar purpose when it chartered Fannie Mae and other guaranty agencies. The Fannie Mae Charter Act, 12 U.S.C. 1716 *et seq.*, declares

Congresses intent to "promote access to mortgage credit throughout the Nation ... by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing." 12 U.S.C. 1716(4). Fannie Mae and other agencies promote mortgage credit by facilitating the secondary market as a guarantor of mortgage-backed securities or as a direct purchaser of residential mortgages. Secondary market sales stimulate the residential lending market by allowing HomeStreet and other lenders to free up capital that is otherwise entirely invested in a relatively small number of loans. CP 161 (Johnson Aff. ¶ 18). This allows HomeStreet and other lenders to make more residential mortgage loans. *Id.*

The DOR's interpretation of RCW 82.04.4292 would deny the B&O tax deduction to the vast majority of mortgage lenders who use the secondary market. This would create the perverse incentive for home mortgage lenders to make fewer mortgage loans and retain those loans in their entirety in their investment portfolios. The DOR's position would dampen rather than stimulate home mortgage lending—the exact opposite of the Legislature's purpose. "The primary goal of statutory construction is to carry out legislative intent." *Cockle v. Dep't of Labor & Indus.*, 142 Wn.2d 801, 16 P.3d 583 (2001). In this case, the DOR's denial of the

statutory deduction is both contrary to the plain language of the statute and the Legislature's intent to encourage residential mortgage lending.

3. HomeStreet's Deduction Is Consistent with the DOR's Own Current Binding Determination.

In 1992, the DOR concluded that HomeStreet was entitled to the deduction under RCW 82.04.4292 for its retained interest because the revenue was interest and HomeStreet's "continued investment in the loan is sufficient to support a deduction under RCW 82.04.4292." CP 154 (DOR Det. No. 92-403 at 8). In 1999, the issued a new determination that purported to limit the deduction under RCW 82.04.4292 to "the owner of the loan or investment" or "the person [who] retains the risk of interest rate fluctuation." CP 106 (DOR Det. No. 98-218, 18 WTD 46, 58 (1999)). The DOR published this determination, designated it as "precedent" pursuant to RCW 82.32.410, and used it as the basis for its assessment of tax against HomeStreet.

The record demonstrates that, even under the DOR's own current standard, HomeStreet retains an asset, retains risk of interest rate fluctuation, and is entitled to the B&O tax deduction. When HomeStreet loans money to borrowers, it is making an expenditure to acquire an asset that it hopes will produce revenue. HomeStreet sometimes retains the entire asset in its portfolio. CP 160 (Johnson Aff. ¶ 12). When it does so,

it services the loan and receives principal and interest payments over the course of the loan. *Id.* In other cases, HomeStreet sells its entire asset to another person. When it does so, the purchaser begins receiving principal and interest payments attributable to the asset. CP 160 (Johnson Aff. ¶ 14). The case at bar involves a third and more common situation in which HomeStreet either securitizes or sells a portion of its loan asset to an investor.⁷ In either case, HomeStreet retains a portion of its loan asset and substantial interest rate risk.

In accordance with generally accepted accounting principles ("GAAP"), the retained interest portion of the original loan asset is kept as an asset on HomeStreet's books. CP 193 (van Amen Aff. ¶ 7). The retained interest asset has value, and can be sold to others. CP 193 (van Amen Aff. ¶ 8). HomeStreet's retained interest assets are subject to numerous risks, which HomeStreet must carefully manage. First, the value of retained interest assets, like portfolio loans, is subject to the risk

⁷ When HomeStreet sells mortgage-backed securities or a portion of its loans to secondary market investors, it receives less money from the investor than if it had sold the entire loan outright without retaining a part of the original asset. CP 233 (Byers Dep. Transcript at 29); CP 197 (Byers Aff. ¶¶ 7-9); CP 160 (Johnson Aff. ¶¶ 13, 14). Thus, the market recognizes that a purchaser is receiving more when it purchases a loan with servicing rights than it does when the originating lender retains an interest. *Id.*

of interest rate fluctuation. CP 193 (van Amen Aff. ¶ 10). HomeStreet's retained interest assets generally fluctuate in value with changes in interest rates. *Id.* HomeStreet's retained interest assets tend to increase in value when interest rates rise and decrease in value when interest rates fall. *Id.* HomeStreet engages in hedging transactions as a way of protecting against the impacts of interest rate fluctuations on the value of its retained interest assets. CP 194 (van Amen Aff. ¶ 11). The value of retained interest assets is also subject to the risk of prepayment and borrower default. CP 194 (van Amen Aff. ¶¶ 13 and 14). If a borrower prepays its loan or defaults on its loan, HomeStreet's retained interest asset becomes worthless because the borrower will not be making future interest payments. *Id.*

In 1992, under the same facts, the DOR concluded that HomeStreet's retained interest was an asset and that HomeStreet "is still looking to the balance of the loan retained in order to fully compensate it for the risks it continues to bear throughout the life of the loan as well as the residual costs it has not recovered." CP 154 (DOR Det. No. 92-403 at 8).

In the present case, the DOR's expert witness testified that the retained interest asset arises from and is embedded in every mortgage loan that HomeStreet originates. CP 50 (Baldwin Dep. Transcript at 136-137).

Further, he testified that the retained interest assets are assets that fluctuate in value:

Q. When [a loan] is sold on a servicing retained basis, the seller retains a servicing asset; is that correct?

A. Correct.

Q. And the servicing asset has value, does it not?

A. It does.

Q. And it's required – that value is required under accounting rules to be accounted for under the owner of that asset's balance statement?

A. That is correct.

Q. And that's an asset whose value can fluctuate over time; is that correct?

A. Yes.

Q. And changes in market interest rates will affect the value of that asset; is that correct?

A. That's one element, yes.

Q. Can you identify some of the – some of the factors that affect the value of servicing assets?

A. Cost to service the loan, prepayment. ...

CP 48-49 (Baldwin Dep. Transcript at 129 – 130). In these respects, retained interest assets are not different than portfolio loans that HomeStreet retains in their entirety and for the DOR allows the deduction:

Q. Okay. If the originator of a mortgage loan holds that mortgage loan in its own portfolio, that loan is an asset to the company, is it not?

A. Yes.

Q. And it's an asset that fluctuates in value with interest rate fluctuations?

A. Yes.

Q. And it's subject to prepayment risk?

A. Yes.

CP 53 (Baldwin Dep. Transcript at 148).

As with a loan retained in its entirety, HomeStreet's retained interest is an asset that remains subject to substantial risks of interest rate fluctuation. As such, HomeStreet's retained interest is deductible under the DOR's current "precedential" determination, DOR Det. No. 98-218, 18 WTD 46, 58 (1999) (holding that the deduction under RCW 82.04.4292 is limited to "the owner of the loan or investment" or "the person [who] retains the risk of interest rate fluctuation"). CP 106.

VI. Conclusion

The plain language of RCW 82.04.4292 does not require that HomeStreet "hold" notes in order to qualify for the B&O tax deduction. It is undisputed that HomeStreet's retained interest revenue was "derived from interest." Therefore, the amounts at issue are deductible under the plain language of RCW 82.04.4292. Accordingly, appellants HomeStreet,

Inc., HomeStreet Capital Corporation, and HomeStreet Bank respectfully request that the Court reverse the decision of the Thurston County Superior Court and remand the case for entry of judgment in favor of appellants refunding \$20,225 in B&O tax paid for the period January 1, 2003 through January 31, 2003, plus statutory interest.

DATED: July 6, 2006.

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HomeStreet Capital Corporation, and
HomeStreet Bank

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DIVISION II
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STATE OF WASHINGTON
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No. 34738-5-II

**COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON**

**HOMESTREET, INC., HOMESTREET CAPITAL
CORPORATION, and HOMESTREET BANK,**

Appellants,

v.

**STATE OF WASHINGTON, DEPARTMENT OF
REVENUE,**

Respondent.

CERTIFICATE OF SERVICE

The undersigned certifies that a copy of the *Brief of Appellants* was served upon attorneys for the respondent this day by legal messenger at the following address:

Donald F. Cofer
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7141 Cleanwater Drive SW
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DATED this 6th day of July, 2006.

A handwritten signature in black ink, appearing to read 'C O'Lague', written over a horizontal line.

Constance O'Lague