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.

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

APPELLANT'S REPLY BRIEF

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I. INTRODUCTION

Much has been written recently about mortgage-backed securities, in particular the packaging and selling of residential mortgage-backed securities and their impact on the financial crisis of 2008. Many of the problems leading to this crisis stemmed from the actions of major players in the industry who made thousands of dubious "subprime" loans, packaged them in mortgage-backed securities, and fobbed off the rotten results on unsuspecting investors.

Cashmere Valley Bank was not one of these players. The wrongdoing that led to the 2008 financial collapse occurred at the front end of the MBS process. Cashmere, a local community bank, participated at the other end as an *investor* in MBS products. Nor did Cashmere invest in subprime products; contrary to the Department's "Z" tranche insinuations, the loans making up the products in which Cashmere invested are not in default, confirming the *prudence* of Cashmere's investment decisions.

Here is what this case is *really* about. Borrowers obtained home loans from banks. The borrowers promised to repay the money they had borrowed, and to pay interest on that amount. They signed promissory notes embodying these promises, and gave mortgages or deeds of trust on their homes (all nontransient residential properties) in support of those promises. The borrowers then proceeded to fulfill their payment obligations in accordance with payment schedules set forth in the

promissory notes, which provided for monthly payments of principal and interest.

Investment bankers took these loans and bundled groups of them together either as collateralized mortgage obligations (CMOs) or real estate mortgage investment conduits (REMICs). The CMOs and REMICs are administered by trustees, whose first obligation is to collect the borrowers' monthly payments of principal and interest. The trustees can fulfill this obligation directly, or by hiring someone like HomeStreet Bank to do the job. *See HomeStreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444, 210 P.3d 297 (2009). Once the monthly payments have been collected, the trustee's next obligation is to take this money and parse it out to the investors, who are the beneficial owners of these payments under the CMO and REMIC investment documents.

Are these payments the product of nothing more than "naked" promises to pay made by the borrowers? Or are these payments secured by collateral given by those who borrowed money and promised to repay it (both the principal and a reasonable rate of interest on that principal)?

The answer should be obvious -- *of course* these payments are secured by collateral. Every borrower making these payments gave either a mortgage or deed of trust in nontransient residential property. If one of the borrowers defaults by failing to make their payments, the trustee has not merely the right *but the duty* to protect the affected investors' payment streams by foreclosing on that mortgage or deed of trust. This

arrangement is the very *quintessence* of a payment stream secured by collateral.

Under RCW 82.04.4292, investors who are "engaged in banking, loan, security or other financial businesses," and whose investments are secured by collateral in the form of mortgages or deeds of trust in non-transient residential property, are entitled to deduct from the measure of their B&O tax the interest portion of the payments they receive from those investments. Because Cashmere is so "engaged[,]" and because the interest payments it received were derived from investments secured by mortgages or deeds of trust in nontransient residential property, Cashmere is entitled to deduct those payments.

II. ARGUMENT IN REPLY

A. The Department's Statement of the Case Is Based on Numerous Averments of Fact Not Supported by Any Citations or by Citations to Matters Not in the Record.

The Department's brief contains a 16-page Statement of the Case. Many of its factual averments are not supported by a citation to the record. Many others are supported only by citation to a University of Notre Dame law review article, authored by one Edward L. Pittman, ECONOMIC AND REGULATORY DEVELOPMENTS AFFECTING MORTGAGE RELATED SECURITIES, 64 Notre Dame L. Rev. 497 (1989). This article is not part of the record of this case, Mr. Pittman was not named as a fact or expert witness by the Department, his deposition was not taken by either the Department or Cashmere, and there is no affidavit or declaration from Mr. Pittman in the record.

This Court is only concerned about the actual *evidence in the record* bearing on Cashmere's investments in CMOs and REMICs, not what a non-witness may have said back in 1989 about a topic that may be only generally related to the subject at hand. Cashmere requests that this Court disregard the Department's fact statements that are unsupported by any citation, or supported only by citations to sources that are not part of the record and not actual evidence submitted to the trial court.[1]

B. The Language of RCW 82.04.4292 Has Been Found to Be Clear and Unambiguous, and Cashmere Is Entitled to the Deduction It Seeks Under That Language.

The language of RCW 82.04.4292 has been found by the Supreme Court to be clear and unambiguous. *See HomeStreet*, 166 Wn.2d at 454 ("the statute is unambiguous and subject to only one interpretation"). In reaching this conclusion, the Supreme Court turned to the dictionary to ascertain the ordinary meaning of the statutory term "derived": "'Derived' is defined as 'to take or receive[,] esp. from a source.'" *HomeStreet*, 166 Wn.2d at 453 (quoting WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 608 (2002)). Based on this definition the court held:

> 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.

HomeStreet at 454.

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[1] The Department's Statement of the Case also contains citations to a second "treatise," 7 J. William Hicks, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 § 1:83 (2012). This article likewise is not evidence, and Mr. Hicks, like Mr. Pittman, was not named as a witness, was not deposed, and did not submit an affidavit or declaration.

The revenue at issue in this case also is derived from interest. The CMO and REMIC trustees or their designated agents collect the monthly principal and interest payments from the borrowers, and after subtracting the fee earned for that work pass on the remainder to the investors. Cashmere seeks to deduct only the interest portion of the payments it receives, and under the plain meaning of RCW 82.04.4292 established by *HomeStreet* these basic facts would end this case in Cashmere's favor, save for the Department's claim that this plain meaning conclusion is somehow trumped by other statutory language -- specifically, the clause of the statute which reads ". . . on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties." The Department admits that the interest payments Cashmere receives are "derived" from investments, but claims the payments do not qualify for the statutory deduction because those investments supposedly are not "primarily secured" -- indeed, according to the Department, not secured *at all* -- "by first mortgages or deeds of trust on nontransient residential property." *See* DOR Brief at 2 (Counterstatement of the Issue).

To begin, the Department's claim conflicts with the ordinary meaning of the statutory term "on," which connects the phrase "derived from interest" to the phrase "investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties." The dictionary defines "on," when used as here to indicate the object of action or motion, as follows:

> **6** – used as a function word to indicate the object of action or motion; esp. . . . (5) *the object in connection with which payment, computation of interest*, reduction, or similar settlement is made <paid off a substantial sum ~ the mortgage> <creditors received about 75 cents ~ the dollar> <a rebate of 15 cents ~ a ton> <an inroad ~ supplies>

WEBSTER'S at 1575 (emphasis added). Applying this definition, the ordinary meaning of the statutory phrase "amounts derived from interest on investments or loans primarily secured by first mortgages or trust deeds" becomes "amounts derived from interest *payments made in connection with* investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties."

Thus, for the deduction to apply, the amounts Cashmere seeks to deduct must have been derived -- "taken," as *HomeStreet* says (166 Wn.2d at 453-54) -- from interest payments made in connection with investments or loans primarily secured by first mortgages or deeds of trust on nontransient residential property. In fact, the amounts at issue here *were* taken from interest payments made in connection with loans to borrowers whose promises to repay were secured by either first mortgages or deeds of trust on nontransient residential property (to wit, their homes). To be sure, Cashmere did not itself make these loans. But Cashmere did *invest* in the payment streams generated by these loans (by investing in the CMOs and REMICs to which those loans had been assigned), and that investment was undeniably secured by the mortgages and deeds of trust given by the borrowers on their homes, against which the CMO and

REMIC trustee would be duty bound to proceed should the borrowers default on their payment stream obligations.[2]

The Department's claim also ignores the Legislature's use of the disjunctive term "or." After reframing the issue here as "whether the amounts Cashmere received from ... investments [in CMOs and REMICs] represented interest received on investments primarily secured by first mortgages or trust deeds on residential properties" (DOR Brief at 1), the Department states:

> ...Cashmere's right to receive interest was based on a defined set of rules set out in the disclosure documents pertaining to the particular class of bond Cashmere purchased, rather than by the terms of any mortgage loan. The interest Cashmere received was *not from any mortgage loans issued or purchased by Cashmere*, and the investments [therefore] were not secured by first mortgages or trust deeds on nontransient residential properties.

Id. at 1-2 (emphasis added). The Department thus asserts that the deduction only applies if the bank claiming the deduction is receiving interest payments either (1) from a loan it made secured by a mortgage or

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[2] The Department contends that Cashmere's reading of the statute would allow a deduction whenever a payor happens to use cash flow from loan payments secured by a mortgage or deed of trust in nontransient residential property to pay money owing to an investor in a separate, unsecured transaction. DOR Brief at 27-34. But in CMO and REMIC investments, the underlying borrowers make payments of principal and interest and those payments are passed through the loan servicer and the trustee before the interest and principal payments are paid to the investors; there is no commingling of principal and interest payments with other revenue streams from third party sources, because there is no other cash flow other than the principal and interest payments received from borrowers who have secured their performance by giving mortgages or deeds of trust in their homes. The Department makes no attempt to describe just how its hypothetical horrible, of an investor attempting to claim a deduction based on the happenstance that it was paid from monies that its obligor received from a third party performing under an obligation that was itself primarily secured by a mortgage or deed of trust on nontransient residential property, could ever be likely to come about.

deed of trust on nontransient residential property, or (2) under an assignment of such a loan.

RCW 82.04.4292, however, allows a deduction from the measure of tax for "amounts derived from interest received on investments *or* loans secured by first mortgages or trust deeds on nontransient residential properties" (emphasis added). The use of the disjunctive "or" means the two words "investments" and "loans" are to be interpreted as alternatives to each other. *Marriage of Caven*, 136 Wn.2d 800, 807, 966 P.2d 1247 (1998) ("[T]he word 'or' . . . grammatically is a coordinating particle signifying an alternative"). As this Court recently stated, "[w]e presume that the word 'or' does not mean 'and' and that a statute's use of the word 'or' is disjunctive to separate phrases *unless there is a clear legislative intent to the contrary.*" *Riofta v. State*, 134 Wn. App. 669, 682, 142 P.3d 193 (citing *HJS Dev., Inc. v. Pierce County*, 148 Wn.2d 451, 473 n.95, 61 P.3d 1141 (2003); *State v. Weed*, 91 Wn. App. 810, 813, 959 P.2d 1182 (1998)) (emphasis added).

By writing both loans *and* investments into the statute, and separating those terms by the disjunctive "or," the Legislature evidenced its recognition that an investment can be something other than an original loan or an assignment of a loan, and expressed its intention that amounts derived from interest payments in connection with such "non-loan" investments should also qualify for the deduction. The Department's contrary interpretation reads the word "investments" completely out of the statute, which flies in the face of the rule that courts must "avoid

construing a statute in a manner that renders a provision meaningless." *Riofta*, 134 Wn. App. at 683 (citing *State v. Contreras*, 124 Wn.2d 741, 747, 880 P.2d 1000 (1994)).

The Department attempts to justify its reading on the ground that "Washington courts have described the purchase of mortgage loans as 'investments.'" *See* DOR Brief at 36 (citing *Kueckelhan v. Federal Old Line Ins. Co.*, 69 Wn.2d 392, 397, 418 P.2d 443 (1966) (characterizing purchases of mortgage loans as investments)). *Case* law, however, hardly constitutes "clear evidence" that the *Legislature* intended to depart from the ordinary disjunctive meaning of "or" when it used the term in RCW 84.04.4292. The Department's argument also ignores that, as originally proposed, the statute would have allowed a deduction *only* for "investments"; the term "loan" and the disjunctive term "or" separating "loan" from the original sole term "investments" were added during the course of the legislative process. *See* CP 120-21; *see also*, CP 101. If the Legislature had intended to limit the deduction to "loans," the bill would have been amended by *replacing* the original term "investments" with the term "loans," not by *adding* the term "loans" while retaining the term "investments."[3]

[3] While legislative history generally is not to be relied upon when a statute is plain and unambiguous, *see, e.g.*, *Burton v. Lehman*, 153 Wn.2d 416, 422, 103 P.3d 1230 (2005), here legislative history is instructive because it establishes that the Department cannot meet its burden to show a clear legislative intent to depart from the ordinary disjunctive reading of the term "or."

C. The Department's Basic Premise -- That Cashmere's Investment Is Not Secured Because Cashmere Itself Cannot Foreclose and Must Instead Depend Upon the Trustee Fulfilling Its Duty to Protect Cashmere's Interests by Exercising Its Authority to Foreclose -- Is Not Supported by the Statutory Language and Defies Economic Common Sense.

The Department concedes that Cashmere has a right to payments from borrowers. DOR Brief at 17 ("[I]nvestors in REMIC certificates receive . . . a right to cash flow"). The Department also does not deny that the trustee has the right to foreclose, should a borrower default on the obligation to make those payments. And the Department further recognizes that, if the trustee is not doing its job, it can be replaced by the vote of just 25 percent of the investors. *Id.* at 18 (citing CP 729).

The crux of the Department's argument is that Cashmere's investment nonetheless is not secured because Cashmere *itself* cannot foreclose, should borrowers default on their payment obligations. The Department thus is effectively saying that, unless Cashmere made the loan, or is an assignee of the loan and has stepped into the shoes of the original lender, and therefore has the right itself to foreclose, Cashmere is not entitled to the deduction.

First, the requirement that an investor have the right itself to foreclose, in order for its investment to be deemed secured, is not found in the statute. If the Legislature had intended to impose such a requirement, it would presumably have taken the familiar form of a proviso that would have read something along these lines: "[P]rovided, however, that the investor must have the right to foreclose against the mortgage or deed of trust in the event of a default by the borrower." Because the statute does

not have that proviso, the Department effectively is asking this Court to add those words. But doing so would violate "the rule of statutory interpretation prohibiting courts from adding words or clauses to an unambiguous statute when the legislature has chosen not to include that language." *State v. Kintz*, 169 Wn.2d 537, 549-550, 238 P.3d 470 (2010) (citing *State v. Delgado*, 148 Wn.2d 723, 727, 63 P.3d 792 (2003); *State v. Thompson*, 151 Wn.2d 793, 800-01, 92 P.3d 228 (2004)).

Second, declaring an investment to be unsecured, merely because the investor itself cannot foreclose in the event of a default, makes no economic sense. As Dr. Alan Hess explained in his report (CP 227-33), there is a basic economic benefit to society when ownership of the cash flow is separated from the right to foreclose should borrowers default on their payment obligation:

> 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.

CP 227-28. Nothing in the statutory language or its recognized purpose supports denying investors in CMOs and REMICs like Cashmere the benefit of the statutory deduction, just because CMOs and REMICS represent a further application of the rule of specialization whose clear social benefit has been recognized as early as the publication of *The*

Wealth of Nations (the same year our country declared its independence from England).[4] The Department has not cited to a single case supporting the notion that an investor with the right to receive a payment stream should be deemed unsecured just because a third party has been charged with the right *and duty* to foreclose on available collateral, should the party obligated to make the payments default on that obligation.

D. The Department Makes Several Points About the Nature of Cashmere's Ownership Interest, Which Actually Support Cashmere's Case for a Refund.

The Department makes several points about the nature of Cashmere's ownership interest, all of which actually support Cashmere's case for a refund.

- The Department states that "[i]n general terms, a mortgage-backed security is created when individual mortgage loans are pooled and 'securitized' by selling investors an interest in the pool." DOR Brief at 4

[4] It is precisely for this reason that, as long as investors receive checks in full each month, they will not and should not have to care how the trustee goes about maintaining that cash flow; the trustee could be foreclosing 10 percent of the loans, but as long as the checks are flowing investors do not care. In fact, assuming a default rate of 10 percent almost certainly exaggerates the amount of loans in foreclosure, at least at the time of the audit of Cashmere by the Department. CP 164-65 (Appendix A) includes documents from one of Cashmere's investments, Washington Mutual Series WAMM52004-RA4. This CMO was issued on October 28, 2004, and the partial report is for the record date of December 31, 2007, and a distribution date (for interest and principal) to the investors of January 25, 2008. This original series (Group 1) included 174 loans. CP 164. As of December 1, 2007, there were still 88 loans left in the series, the other loans having been repaid already. *Id.* During the month of December 2007, one additional loan was prepaid, leaving 87 loans left in the series as of the record date (12/31/2007). *Id.* Most important, as of December 31, 2007, there were zero ($0.00) principal losses (foreclosures) in this series. CP 165. This means that since inception through December 31, 2007, there were 87 loans that had been paid off and no foreclosures in this series.

(citing CP 682-83 (testimony of Cashmere's expert Michael Gamsky discussing what is meant by "securitizing" assets)). Regardless of how "general" the "terms" are, this precisely describes the investments made here by Cashmere -- individual mortgage loans were pooled and securitized (another way of saying a security was created) and investors, including Cashmere, were *sold an interest in the pools*.

The next sentences state that "[t]he manner in which these mortgage-backed investments are created is constrained in large part by federal income tax, securities, and bankruptcy considerations[,]" and that "[t]he simplest form of a mortgage-backed security is the 'mortgage pass-through certificate' (also referred to as a 'mortgage pass-through security' or 'pass-through MBS')" -- which, of course, in 1990 the Department said *qualified* for the deduction. *See* CP 877-78; DOR Brief at 4. The Department then concludes by stating that "[m]ore sophisticated forms of MBSs include mortgage-backed bonds, collateralized mortgage obligations, and real estate mortgage investment conduits." *Id.* Yet the Department does not explain *how* the "more sophisticated" CMO and REMIC securities are any *less* secured than the "simple[r]" "pass-through" MBSs.

The Department does cite the Pittman article (previously discussed) for the proposition that "[a] mortgage pass-through certificate is simply a participation interest in a trust where the purchaser of the certificate receives *beneficial ownership* of a fractional undivided interest in a fixed pool of mortgage loans." DOR Brief at 4 (citing Pittman, 64

Notre Dame L. Rev. at 499) (emphasis added). But it is hard to understand how this statement helps the Department, given that the documents in the record establish that the beneficial ownership interest that Cashmere received under the CMOs and REMICS included an interest ***in the underlying loans themselves***:

> Each series of Certificates will consist of two or more classes, which will represent the *beneficial ownership interest in the series trust* created by the Trust Agreement . . . . *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 in italics and bold added). Indeed, throughout the disclosure documents the investors are repeatedly told they will have a *beneficial ownership* interest in trusts, the underlying assets of which are pools of single-family residential mortgage loans in first-lien positions:

> In general, each underlying security will represent a direct or indirect *beneficial ownership* ***in a pool of mortgage loans***.

CP 723 (emphasis in italics and bold added).

Thus, when the Department asserts that "investors in mortgage pass-through certificates have a beneficial ownership interest in the trust assets (the mortgage loans), while investors in CMOs and REMICs have an ownership interest only in the bond they purchased" (DOR Brief at 15), the record turns out to conclusively refute this assertion. The documents establish that Cashmere is a beneficial owner of the CMO and REMIC trusts in which it has invested, and this ownership interest extends to include beneficial ownership of the loans themselves. Yet this fact totally

undercuts the Department's attempt to distinguish between "simple" "pass-through" MBSs and "more sophisticated" CMOs and REMICS, because investors in *both* receive the same *beneficial* ownership interest in the underlying loans.

- The Department states that "an investor in a standard pass-through MBS 'has an undivided interest in a pool of underlying mortgage loans,' while REMICs have multiple classes and 'different cash flows' depending upon the class of certificate." DOR Brief at 15-16 (citing CP 761-62). To which Cashmere is compelled to answer, "so what?" Just because an interest is divided or allocated on the basis other than pro rata does not mean the investor no longer has a beneficial ownership interest, and nothing in the documents in the record supports drawing such a conclusion. As the Washington Supreme Court explained in *Christiansen v. Dep't of Social Security*, 15 Wn.2d 465, 131 P.2d 189 (1942), a beneficial ownership interest is one that can be enforced by the courts:

> Beneficial interest has been defined as the profit, benefit, or advantage resulting from a contract, or the ownership of an estate as distinct from the legal ownership or control. 1 Bouv. Law Dictionary, Rawles Third Revision, p. 337; Black's Law Dictionary (3rd ed.), p. 206.
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> In *Catholic Missions v. Missoula County*, 200 U. S. 118, 127, 26 S. Ct. 197, 50 L. Ed. 398, [1906], the Supreme Court of the United States defined beneficial ownership as follows:
>
> "The expression 'beneficial use' or 'beneficial ownership or interest' in property is quite frequent in the law, and means in this connection, such a right to its enjoyment as exists where the legal title is in one person and the right to such beneficial use or interest is in another, and where such right is recognized by law, *and can be enforced by the courts, at the suit of such owner or of some one in his behalf.*"

15 Wn.2d at 467 (emphasis the Court's). Here, the "someone on [Cashmere's] behalf" is the CMO or REMIC trustee, and the Department has never denied that the trustee owes a fiduciary duty to Cashmere and the other investors to take all steps necessary to protect their payment streams -- including, if need be, foreclosing on the mortgage or deed of trust given by the (now defaulting) borrower to secure that borrower's performance of their payment obligation.

- The Department nonetheless attempts to make the case that CMOs and REMICs represent interests in unsecured bonds. True, there are secured bonds and there are unsecured bonds.[5] Investors who are willing to buy any unsecured investment know they are taking a bigger risk and the investors are usually rewarded with high interest rates. These investors are akin to riverboat gamblers. To accept the Department's argument is to say that community banks of this state, including

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[5] For example, Fannie Mae describes a type of unsecured bond that is used to provide funds for the mortgage market:

> Fannie Mae provides funds to the mortgage market by purchasing mortgage loans from lenders, thereby replenishing their funds for additional 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.

CP 757 (emphasis added). Fannie Mae also issues MBSs, where investors do have security in the form of the underlying loans:

> 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.

Id.

Cashmere, are also akin to riverboat gamblers when they invest in CMOs and REMICs. This is ridiculous, not only because community banks like Cashmere plainly are *not* riverboat gamblers, but also because investors are told in all the prospecti that they are beneficial owners of "pools of single-family residential mortgage loans generally *in first lien position.*" CP 710 (emphasis added).

The Department attempts at least to make Cashmere *sound* like a riverboat gambler, by its extended discussion of the "Z" tranche. The Department states that "[t]he other typical tranche in a CMO, the zero coupon or 'Z' tranche, receives interest in the form of additional or 'accreted' principal, and investors in the Z tranche receive no payments of principal or interest until other designated tranches are retired." DOR Brief at 10 (citing CP 507.) Yet whether the Z tranche is the last tranche to be paid in no way justifies denying Cashmere the deduction to which it is otherwise entitled. The key point is not whether this tranche is paid first, last, or in the middle, but that when it is paid the payments consist of principal and *interest*, and there is no dispute in this record that Cashmere is seeking a deduction only for *interest* payments that in fact *have* been made and received.

- The Department at one point actually asserts that "[m]ortgage pass-through certificates . . . differ from CMOs and REMICs" because "mortgage pass-through certificates (*unlike CMOs and REMICs*) represent a beneficial ownership of a fractional undivided interest in a fixed pool of mortgage loans." DOR Brief at 14-15 (emphasis added).

The Department cites as support for this proposition Clerk's Papers page 619, which is page 102 of the deposition of Chirag Shah.

Mr. Shah was talking about the concept of pass-through, and at that point in his deposition Mr. Shah was asked some questions about CMOs. If one reads only the exchanges found on that page cited by the Department, one might get the impression that Mr. Shah was saying that investors in a CMO do not receive a beneficial ownership interest in the underlying security. But if one continues to read CP 620, 621, 622, and especially CP 621 (page 104 of the deposition), it becomes clear that Mr. Shah was *not* saying that investors in CMOs and REMICs do not receive a beneficial ownership in the underlying security.[6]

Moreover, at one point Mr. Shah is asked whether ownership of the loans is something that would be specified in the prospectus and trust documents, and Mr. Shah's answer is *yes*. CP 621-622. Given this statement, it is truly remarkable that the Department would go so far as to assert: "Simply put, investors in mortgage pass-through certificates have a beneficial ownership interest in the trust assets (the mortgage loans), while investors in CMOs and REMICs have an ownership interest only in the bond they purchased." DOR Brief at 15. Yet that statement is directly contradicted by the prospectus and trust documents found in the record:

> In general, each underlying security will represent *a direct or indirect beneficial ownership interest in a pool of mortgage loans.*
>
> . . .

[6] CP 619-622 are attached to this brief as Appendix B.

> Fannie Mae also issues and guarantees other mortgage-backed securities that involve more than one class of certificates and, therefore, require special allocations of cash flows. SMBS are issued in series, with one or more classes, each of which is entitled to different cash flows and may represent (a) an undivided interest solely in the principal payments, (b) an undivided interest solely in the interest payments or (c) different percentage interests in principal and interest payments, to be made on a pool of mortgage loans, MBS, REMICs, other SMBS and/or Ginnie Mae certificates. *REMICs represent beneficial interests in a trust having multiple classes of certificates entitled to different cash flows from the underlying mortgage loans, MBS, SMBS, Megas, Ginnie Mae certificates and/or certificates from other REMICs.* Pursuant to the guaranty provided to REMICs and SMBS certificate holders, Fannie Mae is obligated to make timely distribution of required installments of principal and/or interest and, in the case of REMICs, to distribute the principal balance in full by a specified date, whether or not sufficient funds are available in the related REMIC trust.

CP 723, 761-62 (emphasis added).

In short, investors in CMOs and REMICS *do* receive a beneficial ownership interest in the underlying loans that have been bundled and placed in the CMO and REMIC trust. And this fact sweeps away the *only* specific distinction between traditional "pass-through" MBSs and CMOs and REMICs which the Department has offered to justify denying deductibility to interest payments received from investments in CMOs and REMICs.[7]

---

[7] Cashmere recognizes that not all investors in CMOs and REMICs are entitled to the tax deduction; it is only those engaging in "banking, loan, security or other financial businesses" (RCW 82.04.4292) that qualify for the deduction. So, if Microsoft or Boeing were to invest in CMOs or REMICs, they would not be entitled to the deduction and would pay the B&O tax on this interest income. In short, it is only a narrow category of taxpayers that the Legislature has said are entitled to the deduction -- taxpayers in the thick of the residential mortgage market who are needed to help expand the total amount of funds available for housing and increase the liquidity of residential mortgage loans. And this includes the Cashmeres -- the community banks -- of the world. The scope of the tax deduction at one time also included the Wells Fargo and Bank of Americas of the world, too, but the Legislature has now cut off the availability of the deduction for this

(Footnote is continued on next page.)

- The Department states that "[n]one of the REMICS . . . pledged any interest in real property to back up the trustees' commitment to pay." DOR Brief at 16. To which Cashmere is again compelled to respond, "so what?" The investors do not care about recourse against the trustee. If the trustee does not do its job and does not proceed to foreclose when it should be proceeding to foreclose, twenty-five percent of the investors can get together and replace the trustee and bring in a new trustee who will fulfill the trustee's fiduciary obligations. CP 729. In short, the issue of personal recourse against the trustee is a red herring. The relevant issue is whether Cashmere's cash flow, which is what Cashmere invested in, is a secured investment, and it *is* a secured investment because the trust holds the mortgages and the deeds of trust that have been given by the borrowers who are paying the loans.[8]

E. The Legislature Did Recently Act to Limit the Deduction, But That Change Does Not Support the Department's Case for Denying the Deduction to Cashmere.

The Department brings up the 2011 Tax Preference Performance Review (issued January 2012) prepared by the Joint Legislative Audit & Review Committee ("JLARC") (*see* DOR Brief at 46), but the ensuing discussion of that report only tells half of the story. The report (relevant

---

latter group of financial businesses. In sum, this is not a tax deduction every investor receives and some investors were never eligible for this deduction in the first place.

[8] Cashmere's investments in CMOs and REMICs underwritten by the various federal agencies (Fannie Mae, Freddie Mac, and Ginnie Mae) were further secured because the payments of interest and principal to the investors were unconditionally guaranteed by these federal agencies.

portion attached as App. C) expressed doubts about whether RCW 82.04.4292 produced the social, economic and other gains that were intended. In response the Legislature passed Engrossed Senate Bill (ESB) 6635 (Chapter 6, Laws of 2012). ESB 6635 was approved by Governor Gregoire on May 2, 2012, and becomes effective July 1, 2012. ESB 6635 repealed the deduction, but only as to banks doing business in more than ten states. *Id.* §§ 101, 102.[9]

Therefore, responding to the same criticism featured by the Department in its brief to this Court, the Legislature changed the law and limited the deduction so that the largest interstate banks -- the Wells Fargoes, Banks of America and JP Morgan Chases of the world -- are no longer allowed to take the deduction. The deduction was retained, however, for all other banks (including the Cashmere Valleys of our state). In short, the Legislature made a policy judgment that this deduction was achieving its purpose at the local level and should be retained for those banks contributing to that effect. In effect, the Legislature drew the line between the large banks that created the subprime mortgage mess and the community banks like Cashmere who managed their mortgages and investments properly. In sum, the Department's policy argument for denying Cashmere the benefit of the deduction, based on recent criticisms of the deduction's effectiveness, ignores that the Legislature just

---

[9] An excerpt of ESB 6635 containing the amendment to RCW 82.04.4292, is attached to this brief as Appendix D.

reaffirmed that the deduction should continue to be available to banks like Cashmere.

F. The Department's "Too Many Steps Removed" Test for Determining Whether Investment Income Qualifies for the Deduction Has No Basis in the Statutory Language and Disregards Legislative Purpose.

The Department recognized in 1990 that pass-through mortgage securities qualified for the deduction, but concluded that CMOs and REMICs do *not* qualify because they are "an additional step removed" from the original borrower's payment obligation. Yet the statute says nothing about deductibility turning on how many "steps" a payment is "removed" from the borrower's original obligation to make that payment. In 1970, when RCW 82.04.4292 was enacted, *no* form of MBSs existed. The intermediary position of the trustee was created as part of the subsequent development of CMOs and REMICs, which in turn depended upon computer technology breakthroughs likely unimaginable to any member of the Legislature that passed RCW 82.04.4292. It is all too apparent that the Department's rejection in 1990 of eligibility for CMOs and REMICs is just another example of arbitrary bureaucratic line-drawing that so often results, when a process of ongoing change reaches the point where a previously accepting bureaucracy comes to view it with suspicion, and tries to "stop the clock" by an exercise of bureaucratic power having no basis in the agency's statutory grant of authority.

The Department fails to acknowledge, when comparing older MBSs to the newer CMOs and REMICs, that the trustee employed by the

latter is a fiduciary who is bound by well-established principles of fiduciary duty law to look out for the interests of the trust beneficiaries (the investors). The Department also fails to identify an actual and material distinction between an MBS investment that is a straight pass-through, and an MBS that operates through an intermediary trustee bound by a fiduciary duty to protect the interests of investors. The Department nevertheless in 1990 presumed to create such a distinction, but there is no basis for it either in the language of the statute *or* its recognized purpose.

The 2011 Tax Preference Performance Review of the Joint Legislative Audit & Review Committee acknowledged that the statute's original purpose was to encourage Washingtonians to buy homes by making loans more available and less expensive. *See* App. C (report pps. 11, 89 & 96). The statutory had previously been recognized by this Court in *Dep't of Revenue v. Security Pacific Bank*, 109 Wn. App. 795, 804, 38 P.3d 354 (2002) ("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'" (alteration in original)), and later by the Supreme Court in *HomeStreet*, 166 Wn.2d at 454 (quoting this Court in *Sec. Pac. Bank*). That the Department's position on the deductibility of interest from investments in CMOs and REMICs conflicts with this purpose is confirmed by the CMO and REMIC prospectus statements set forth in the record:

> Fannie Mae provides funds to the mortgage market by purchasing mortgage loans from lenders, *thereby replenishing their*

> *funds for additional 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).

If the purpose of a deduction is not being fully met, as the 2012 JLARC seemed to conclude was the case with RCW 82.04.4292, then it is up to the Legislature to change the law. (And, as shown, the Legislature has decided to eliminate the deduction only for interstate megabanks.). It is not for the tax bureaucracy (or the courts) to change policy otherwise reflected in the plain language of the statute, as well as the recognized purpose of the Legislature when it enacted the statute. The Department's action in 1990, presuming to draw lines of deductibility based on notions of too many "degrees of separation" when neither statutory language nor legislative purpose supports drawing such a line, should be rejected as beyond the Department's authority and therefore of no force or effect. *See, e.g.*, *Lone Star Industries, Inc. v. Dep't of Revenue*, 97 Wn.2d 630, 634-35, 647 P.2d 1013 (1982) (agency interpretation entitled to no deference when it conflicts with clear and unambiguous statutory language).[10]

---

[10] The 2012 JLARC report has a section titled "What Qualifies as Deductible Interest." App. C (report p. 94). It states that in 1986 "Interest on mortgage-backed securities" was

(Footnote is continued on next page.)

G. The Department's Supposed Longstanding Interpretation Is Entitled to No Deference From This Court.

Courts will defer to an agency's interpretation of a statute, but only if the statute is ambiguous. *See Campbell v. Dep't of Social and Health Services*, 150 Wn.2d 881, 894 n.4, 83 P.3d 999 (2004). Here, as found by the Supreme Court in *HomeStreet*, the key language of RCW 82.04.4292 is not ambiguous. Courts are fully capable and authorized to overrule an agency interpretation that may have been in place even longer than the two decades the Department claims for its interpretation here, where that interpretation conflicts with the plain meaning of the statute. *See, e.g., Lone Star Industries* (*supra*), 97 Wn.2d at 634-35 (longstanding Department rule was found to be invalid because it imposed requirements "more broadly" than authorized by statute (RCW 82.04.050) and in doing so "ignored the plain language" of the statute).

Moreover, Cashmere must confess its astonishment that the Department would urge this Court to defer to a single ruling of a Department administrative law judge (ALJ), which is the *only* source of the so-called "longstanding" interpretation at issue here, given this Court's recent decision in *Wells Fargo Bank, N.A. v. Department of Revenue*, 166 Wn. App. 342, 271 P.3d 268 (2012). In that case, this Court noted how

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was determined to be tax-deductible. *Id.* There was no qualification to this statement. In other words, the report does not state that only *certain* MBSs qualify, as the Department represents to this Court, nor does the report state that classic MBSs are deductible but CMOs and REMICs are not, or that an MBS does not qualify for the deduction if it is "an additional step removed." Rather, the report indicates that *all* MBSs qualify for the deduction. And this report was authored, in part, by the Department itself. *See id.* (Mary Welsh and Dana Lynn, Department employees, were members of the JLARC "Study Team"). (*See* App. C, page 1).

the Department describes its ALJs, and how the Department *expressly abjured that its ALJs were anything more than agency employees and went on to state that their decisions were **not** entitled to deference in proceedings involving a different taxpayer*:

> In its briefing, DOR states that, due to the informal and non-adversarial appeal proceedings, its ALJs are not third-party neutrals but employees of DOR "'trained in the interpretation of the Revenue Act and precedents established by prior rulings and court decisions.' " Br. of Resp't. at 3 (quoting WAC 458-20-100(5).

Id. at 342, n.1; *see* App. F (copy of pages from DOR brief cited by this Court at 3). The Department's claim of longstanding agency interpretation is groundless and this Court should give it no weight.[11]

H. The Legislature Did Not Acquiesce in the Department's Interpretation.

RCW 82.04.4292 was enacted in 1970, originally as subsection 10 of former RCW 82.04.430. 1970 1st ex. sess. ch. 101. *See* App. E, p. 5. The statute was amended ten years later, in 1980, but this amendment merely inserted the deduction into a separate, stand-alone statutory section. 1980 c 37 § 12. The first substantive amendment was not made

---

[11] *Wells Fargo* is not the first time the Department has dismissed its own ALJ determinations. In *Tesoro Refining and Marketing Company v. Department of Revenue*, 173 Wn.2d 551, 269 P.3d 1013 (2012), the Department had issued *three* unpublished determinations to similarly situated taxpayers other than Tesoro, which had granted the B&O tax deduction that Tesoro was seeking in its litigation. But when Tesoro asked to have the deduction applied to its taxes the Department refused, and the Supreme Court went along with the Department, holding that Tesoro did not qualify for the deduction under the plain language of the statute "regardless of the *incidental* and contrary agency interpretations." *Id.* at 557-58 (emphasis added). (The word "incidental" is defined in part to mean "subordinate, nonessential, or attendant in position or significance." Webster's, *supra* at 1142.)

to RCW 82.04.4292 until 2010, *after* the period of 2004-2007 at issue here, when the statute was amended to deal with the aftermath of the Supreme Court's decision in *HomeStreet*. 2010 1st sp.s. c 23 §§ 301. The next substantive amendment was made earlier this year, to (as previously noted) take the deduction away from the biggest of interstate banks. Chapter 6, Laws of 2012 §§ 101, 102.[12].

To support a claim of "legislative acquiescence" there has to be some evidence of the Legislature having had actual knowledge of the administrative interpretation of a statute in order to have acquiesced in that interpretation. *Dep't of Labor & Industries v. Landon*, 117 Wn.2d 122, 127, 814 P.2d 626 (1991). The mere fact of the Legislature's *inaction* following an agency's interpretation -- such as the issuance of the Department's 1990 determination here -- is not sufficient to establish a legislative acquiescence in that interpretation. *Id.* ("The Department presents no evidence that its interpretation had actually attracted the Legislature's attention"). Here, there is no evidence that the Legislature was ever aware of the 1990 ALJ decision that is the sole basis for the Department's claim of a "longstanding" interpretation.

I. Cashmere Has Not Misread *HomeStreet* or *Security Pacific*.

The Department states that in *HomeStreet* "the court *implied* that if HomeStreet had been hired to service loans purchased by a trustee such as Fannie Mae -- loans which HomeStreet had not originated -- HomeStreet

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[12] A copy of RCW 82.04.4292 along with its complete legislative history is attached to this brief as Appendix E.

would not qualify for the deduction." DOR Brief at 30 (emphasis added). The court did *not* "imply" any such thing, and the only source of the Department's "implication" is taken from the court's statement of facts and not from its discussion of the legal principles that governed the disposition of that case. *Id.* (citing *HomeStreet*, 166 Wn.2d at 448, 453). Cashmere agrees that HomeStreet was a loan servicer, and that it originated the loans from which it sought the deduction for the amount of the fee that it received for servicing these loans. But these are distinctions without a legal difference. The issue in *HomeStreet* was whether the servicing fee HomeStreet received was deductible under RCW 82.04.4292, and the court held that the deduction did apply because under the agreement among the parties the fee paid to HomeStreet was taken from the interest portion of the payment made by the borrower. *See* 166 Wn.2d at 451.

The Department asserts that "Cashmere argues that ownership of the loans is not a requirement for taking the deduction" and that "[b]oth *HomeStreet* and *Security Pacific* held otherwise." DOR Brief at 31 (citing Appellant's Brief at 29, 32). Yet neither decision held that such a requirement existed; in fact, neither decision so much as *hinted* at such a holding even by way of dicta, and there is *nothing* in either of those cases that supports the statement that ownership of the loan is a requirement of the deduction. The Department also asserts that the Supreme Court "relied on a direct connection between the mortgage borrowers and HomeStreet." DOR Brief at 29. Yet there is nothing in *HomeStreet* that supports finding

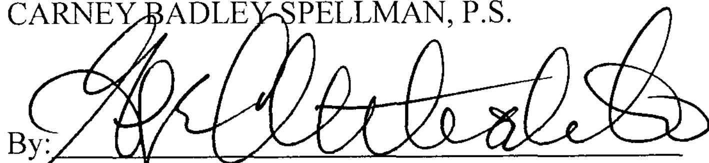
any such reliance on something so utterly unsupported by the language of the statute. The Department further says the court "emphasized th[e] ownership connection" between loans sold by HomeStreet in their entirety and loans in which HomeStreet retained the servicing rights ("'borrowers continued to make principal and interest payments to HomeStreet *because HomeStreet still owns a portion of the loan* and services the loans for the secondary lenders'"). DOR Brief at 28 (quoting *HomeStreet* at 448 (emphasis added *by Department*)). Yet it is the Department which has supplied the emphasis, not the court; in fact there is nothing in *HomeStreet* that "emphasizes" that ownership is a requirement for entitlement to take the deduction.

III. CONCLUSION

The trial court should be reversed, and a refund ordered.

RESPECTFULLY SUBMITTED this 28th day of June, 2012.

CARNEY BADLEY SPELLMAN, P.S.



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Cashmere Valley Bank v. Department of Revenue (DOR)
CASE NO. 42514-9-II

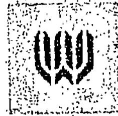
APPELLANT CASHMERE VALLEY BANK'S APPENDICES TO REPLY BRIEF

APP.	DECRIPTION	CLERK'S PAPERS PAGES
A	01/25/2008 Report on one of Cashmere Valley Bank's investments, Washington Mutual Series WAMM52004-RA4 utilized in DOR audit (shows no foreclosures)	164-165
B	11/05/2010 Excerpt from Chirag Shah Deposition re mortgage pass-through certificates, CMOs and REMICs	619-622
C	Excerpt from *2011 Tax Preference Performance Reviews, Report 12-2* (2012), pages 1, 11, 89-100	n/a
D	Excerpt from Chapter 6, Laws of 2012	n/a
E	RCW 82.04.4292 and Legislative History 1970-2012	n/a
F	Excerpt from 12/28/2010 Department of Revenue, Respondent's Brief, from *Wells Fargo v. Dep't of Revenue*, Case No. 40923-2-II	n/a

APPENDIX

A

Series: WAMMS 2004-RA4
Issue Date: 10/28/2004
Record Date: 12/31/2007
Distribution Date: 01/25/2008



Washington Mutual

Collateral Report Group 1

LOAN COUNT	
Original Loan Count	174
Beginning Loan Count	88
Loans Added	0
Loans Prepaid-in-full	1
Loans Liquidated-in-full	0
Loans Repurchased	0
Ending Loan Count	87
PRINCIPAL BALANCE	
Original Scheduled Principal Balance	$29,050,792.89
Beginning Scheduled Principal Balance	$9,697,929.04
Scheduled Principal Received or Advanced	$158,280.07
Unscheduled Principal	$20,198.64
Prepayments-in-full	$22,636.95

0-000000164

Series: WAMMS 2004-RA4
Issue Date: 10/28/2004
Record Date: 12/31/2007
Distribution Date: 01/25/2008

Washington Mutual

Collateral Report Group 1 (Continued)	
PRINCIPAL BALANCE	
Liquidations-in-full	$0.00
Repurchases	$0.00
Principal Losses	$0.00
Ending Scheduled Principal Balance	$9,496,813.38
INTEREST	
Accrued Interest at Gross Rate	$51,197.21
Unscheduled Interest	$0.00
Uncollected Interest	($10.09)
Relief Act Shortfall	$0.00
Prepayment Interest Shortfall	$0.00
Other Interest Shortfall	$0.00

0-000000165

APPENDIX

B

1 Q Okay. I'm with you then.
2 There's also something called a pass-through?
3 A Correct.
4 Q And a pass-through, as I understand it, would be a pool
5 of mortgages where investors would invest in that --
6 they would essentially be beneficial owners of that
7 trust of a pool of mortgages?
8 A Correct.
9 Q But in that case, that pool of mortgages is not -- the
10 cash flow is not being collected and then redistributed
11 in any way; it's being collected and paid out
12 proportionately to your ownership interest?
13 A Correct. Pro rata.
14 Q Pro rata. And then what you would do when you would
15 create a CMO, is you would either take mortgages and
16 pool them or purchase a pass-through mortgage-backed
17 security that's already been pooled and collateralized
18 or pooled and securitized and use that as the
19 collateral for the CMO?
20 A Yes. So the pools would already be -- would already
21 be in existence, and we'd take those pools, and then
22 that's -- on the agency side, that's when we would
23 create the CMO.
24 Q Now, if you're creating the CMO for a private label,
25 when you say you take the mortgage-backed -- or take

1 the pass-through mortgage-backed security, does that
2 mean you purchase it; you become the owner of it?
3 A On the nonagency side --
4 Q On the nonagency.
5 A -- it works out differently where you're starting out
6 with individual loans, and even to create that
7 pass-through, from day one it's a CMO because it's
8 not -- you don't have a pro rata distribution because
9 there is a certain way the prospectus writes how the
10 subs, subordinate bonds, receive principal, and it's
11 actually locked out in the beginning.
12 Q So with the private labels, it's normally -- the
13 underlying collateral for the CMO is normally going to
14 be mortgage, you know --
15 A Individual mortgages.
16 Q So it's sort of a direct link to the mortgages instead
17 of with the government agency issues it's generally a
18 link to a pass-through mortgage-backed security which
19 has a group of mortgages?
20 A Right. So it's all the underlying borrowers comes
21 into -- well, at the end of the day, when you pay into
22 the CMO, it goes from the underlying borrowers, and
23 the trustee will determine how to syphon it to the
24 investors.
25 Q Do you happen to know in the government-sponsored

1 entity CMO issues if the direct underlying collateral
2 is a pass-through mortgage -- MBS -- and I assume there
3 would be more than one; you would probably have several
4 of them?
5 A Several pools.
6 Q Okay. Do you happen to know in that circumstance who
7 owns the loans?
8 A Who owns the loans in...?
9 Q Yeah. Are the loans owned by the lenders, or are the
10 loans owned by the pass-through MBS trust, or are the
11 loans owned by the CMO trust, or --
12 A Right.
13 Q -- somebody else?
14 A So the investor has a right to the principal and
15 interest payments that come off from it. And also
16 when you -- when you do these CMO structures, you're
17 actually selling the bonds off to your balance sheet
18 so it's not on Banc of America's balance sheet
19 anymore.
20 I don't know what officially is said as to like
21 who owns, but I know you as an investor have the right
22 to those principal and interest cash flows that come
23 out.
24 Q So would the -- would the ownership of the loans be
25 something that would be specified in the prospectus,

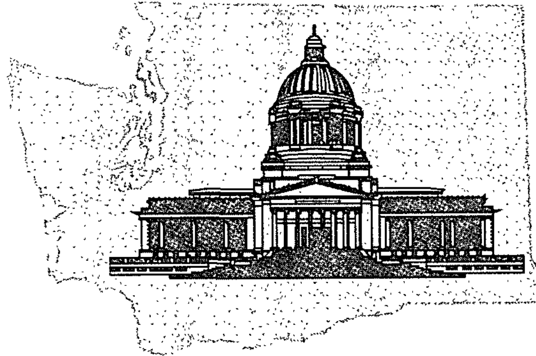
Electronically signed by Barbara Hayden (301-345-524-6083) 04d5ffb1-3405-4d2e-9efe-b8256975be1a

1 prospectus supplement, trust document, some document
2 that's been created?
3 A There should be some governing document that explains
4 it.
5 Q All right. So then let's go back to our Exhibit 18.
6 We've got a list of -- the lead-in before the bullet
7 points is "The steps include:" so I'm assuming that
8 this bullet point of six things is not exclusive.
9 So let me ask you, first of all, other than the six
10 steps listed in this e-mail, are there other steps
11 involved? Are we missing any steps?
12 A This seems to summarize it pretty well. If I can
13 think of anything as it comes forward, I'll definitely
14 say.
15 Q But as you sit here now, you don't anticipate
16 testifying at trial of a seventh or some other step
17 that we don't have listed here?
18 A The current -- currently the way that I see it, I do
19 not.
20 Q So let's go through these kind of quickly then.
21 So the first step is the mortgage lender extends a
22 loan to a homeowner, creates a mortgage, correct?
23 A Correct.
24 Q And then the lender sells that loan?
25 A The -- so the lender can do, you know, one of two

APPENDIX

C

State of Washington
Joint Legislative Audit & Review Committee (JLARC)



2011 Tax Preference Performance Reviews

Proposed Final Report

January 2012

Upon request, this document is available in alternative formats for persons with disabilities.

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Derek Stanford
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Legislative Auditor

Keenan Konopaski

Audit Authority

The Joint Legislative Audit and Review Committee (JLARC) works to make state government operations more efficient and effective. The Committee is comprised of an equal number of House members and Senators, Democrats and Republicans.
JLARC's non-partisan staff auditors, under the direction of the Legislative Auditor, conduct performance audits, program evaluations, sunset reviews, and other analyses assigned by the Legislature and the Committee.

The statutory authority for JLARC, established in Chapter 44.28 RCW, requires the Legislative Auditor to ensure that JLARC studies are conducted in accordance with Generally Accepted Government Auditing Standards, as applicable to the scope of the audit. This study was conducted in accordance with those applicable standards. Those standards require auditors to plan and perform audits to obtain sufficient, appropriate evidence to provide a reasonable basis for findings and conclusions based on the audit objectives. The evidence obtained for this JLARC report provides a reasonable basis for the enclosed findings and conclusions, and any exceptions to the application of audit standards have been explicitly disclosed in the body of this report.

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2011 Tax Preference Performance Reviews

Proposed Final Report

January 2012

STATE OF WASHINGTON
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REPORT SUMMARY

What Is a Tax Preference?

Tax preferences are exemptions, exclusions, or deductions from the base of a state tax; a credit against a state tax; a deferral of a state tax; or a preferential state tax rate. Washington has nearly 590 tax preferences.

Why a JLARC Review of Tax Preferences?

Legislature Creates a Process to Review Tax Preferences

In 2006, the Legislature expressly stated that periodic reviews of tax preferences are needed to determine if their continued existence or modification serves the public interest. The Legislature enacted Engrossed House Bill 1069 to provide for an orderly process for the review of tax preferences. The legislation assigns specific roles in the process to two different entities. The Legislature assigns the job of scheduling tax preferences, holding public hearings, and commenting on the reviews to the Citizen Commission for Performance Measurement of Tax Preferences. The Legislature assigns responsibility for conducting the reviews to the Joint Legislative Audit and Review Committee (JLARC).

Citizen Commission Sets the Schedule

The Legislature directed the Citizen Commission for Performance Measurement of Tax Preferences to develop a schedule to accomplish a review of tax preferences at least once every ten years. The Commission is directed to omit certain tax preferences from the schedule, such as those required by constitutional law.

In October 2010, the Commission adopted its fifth ten-year schedule for the tax preference reviews. This volume includes reviews of a total of 25 tax preferences under the business and occupation tax, sales tax, use tax, property tax, aircraft fuel tax, and the real estate excise tax.

Summary of 2011 Tax Preference Performance Reviews

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Staff Recommendation
Interest from State and Municipal Obligations (Business & Occupation Tax) / 82.04.4293 — Detail on page 85			
Provides a B&O tax deduction to financial businesses for gross income received as interest from state and municipal government obligations.	The Legislature did not specifically state the public policy objective of the preference. JLARC infers that the public policy objective is to provide consistent tax treatment for interest income from all forms of government obligations.	$1.8 million in 2011-13 Biennium	**Continue**: Because the implied public policy objective of ensuring that tax treatment is consistent for interest from state, municipal, and U.S. government obligations is being achieved.
Commission Comment: Commission endorses the JLARC staff recommendation.			
Interest on Real Estate Loans (Business & Occupation Tax) / 82.04.4292 — Detail on page 91			
Provides a B&O tax deduction to banks and other financial businesses for interest derived from investments or loans primarily secured by first mortgages or trust deeds on non-transient residential properties in Washington.	The Legislature did not specifically state the public policy objective of the preference. Documents from the period of enactment suggest the original purpose was to encourage Washingtonians to buy homes by making loans more available and less expensive.	$172.6 million in 2011-13 Biennium	**Review and clarify**: Because it is unclear whether the original public policy objective applies, given changes in the lending industry and the rise in the secondary mortgage market.
Commission Comment: The Commission endorses the recommendation that the Legislature should review and clarify the public policy objective of the preference and should consider whether the preference is essential to maintaining competitive residential lending capability for state-domiciled residential real estate lenders. **Rationale**: The Legislature did not specify a public purpose for this preference. JLARC staff inferred from the record that the implied public policy purpose was to encourage Washingtonians to buy homes by making loans more available and less expensive. However, if the deduction were to be removed, the holder of the residential mortgage loan would bear the full burden rather than the borrower, unless the elimination of the deduction applied only to loans originated or purchased after the effective date of the repeal of the deduction. On a prospective basis the portfolio lender could attempt to recoup the cost of the B&O tax by charging a higher interest rate to the borrower; however, the mortgage market is national in scope, which virtually makes it impossible to charge interest-rate differentials on a geographic basis. As is often the case when the B&O gross receipts tax is involved in a preference, another unstated public policy purpose may be to assure competitive balance with similarity situated business firms in other states subject to other types of tax regimes. The Commission received testimony that removal of the deduction would place a burden on state-domiciled residential mortgage lenders that retain the loans they originate in their portfolios.			

INTEREST ON REAL ESTATE LOANS (BUSINESS & OCCUPATION TAX)

Report Summary

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Recommendation
Provides a B&O tax deduction to banks and other financial businesses for interest derived from investments or loans primarily secured by first mortgages or trust deeds on non-transient residential properties in Washington.	The Legislature did not specifically state the public policy objective of the preference. Documents from the period of enactment suggest the original purpose was to encourage Washingtonians to buy homes by making loans more available and less expensive.	$172.6 million in 2011-13 Biennium	**Review and clarify:** Because it is unclear whether the original public policy objective applies, given changes in the lending industry and the rise in the secondary mortgage market.

INTEREST ON REAL ESTATE LOANS (BUSINESS & OCCUPATION TAX)

Report Detail

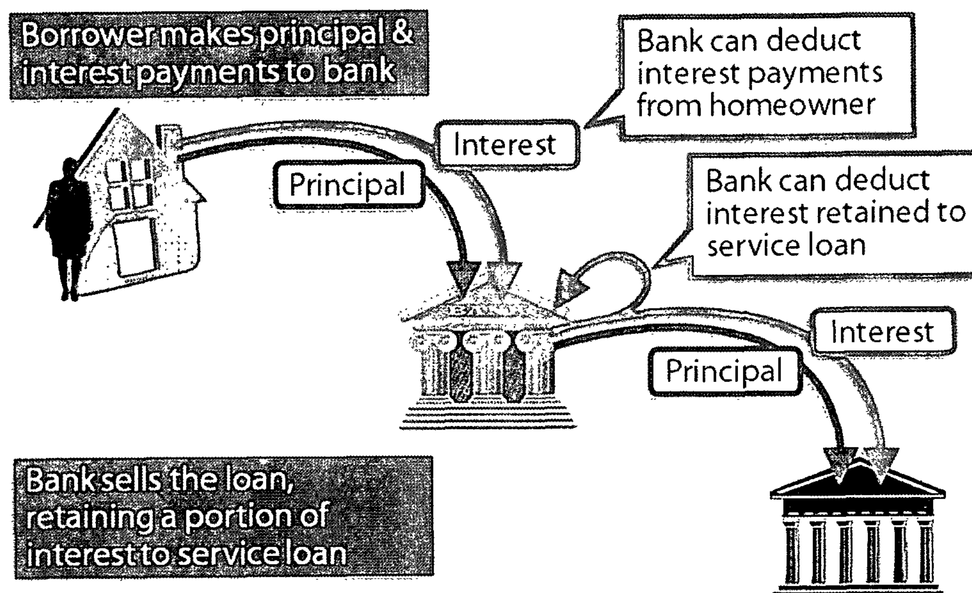
Current Law

This tax preference provides banks and other financial businesses a business and occupation (B&O) tax deduction for interest derived from investments or loans primarily secured by first mortgages or trust deeds on non-transient residential properties in Washington. A deduction is also allowed to the original lender (or successor) for amounts received from servicing loans that have been sold on the secondary market, as long as the servicing fee is based on a percentage of interest paid by the borrower.

Financial businesses include banking, lending, and security businesses. A ***first mortgage*** is the first loan secured by a property, often used to purchase the property. Therefore, home equity loans do not qualify for the exemption if they are second in line to be paid upon sale of a home. ***Non-transient residential property*** is a permanent residence and not a hotel or motel.

The following exhibit provides two examples of the operation of this preference. The first is a simple example of a deduction where a home loan is held by one bank. The second is a more complex example where the bank sells the home loan on the secondary market to investors. Exhibit 28, below, illustrates these transactions.

Exhibit 28 – Mortgage Loan Transactions



Source: JLARC analysis of tax law.

Deductible interest includes amounts received by a financial business to service certain loans after it sells the loan or loan security on the secondary market.

Financial businesses can only deduct amounts paid to service loans if those amounts are:

- Determined by a percent of the interest;
- Received only if the borrower makes payments; and
- Based on a loan originated by the financial businesses claiming the deduction.

A deduction is also allowed for fees charged to borrowers (including points and loan origination fees) that are recognized over the life of the loan as an adjustment to the loan payment.

Financial businesses cannot deduct:

- Fees not recognized over the life of the loan, such as fees for services (such as document preparation fees, finder fees, brokerage fees, title examination fees, fees for credit checks, notary fees, and loan application fees);
- Fees received in consideration for an agreement to make funds available for a specific period of time and terms (commonly referred to as commitment fees);
- Gains of the sale of valuable rights; and
- Gains on the sale of loans.

See page A3-4 in Appendix 3 for the current statute, RCW 82.04.4292.

Legal History

National banks are governed by federal banking law. State banks are governed by the state banking authority. In Washington, the banking authority is the Department of Financial Institutions (DFI).

Pre-1969 The Legislature attempted unsuccessfully to tax the income of national banks in 1929, 1933, and 1935. In all three instances, the courts found the tax to be in violation of the U.S. Constitution.[6, 7, 8] The Legislature consequently decided it would not tax state banks. As a result, Washington exempted from B&O taxation all income from bank loans of any kind.

1969 Congress reversed long-standing prohibitions and allowed states to tax national banks, but not federally chartered credit unions.

1970 The state Legislature repealed the B&O exemption for national and state banks and certain other financial institutions.

In the same bill, the Legislature provided four specific deductions to maintain the tax status of certain financial income:

[6] *National Bank of Commerce v. King County,* 153 Wn. 351, 1929.

[7] *Aberdeen Saving & Loan v. Chase,* 157 Wn. 351, June 1930.

[8] *First National Bank of Kirkland v. Henneford,* No. 16135 (Thurston County Super. Ct. 1936), cited in 6th Biennial Report of the Tax Commission, for the period ending September 30, 1936.

1) For **financial businesses**, amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on non-transient residential properties (the subject of this review);
2) For **financial businesses**, amounts derived from interest paid on all obligations of the state, its political subdivisions, and municipal corporations (the subject of a separate 2011 review);
3) For **lending institutions owned exclusively by its borrowers or members engaged solely in making loans for agricultural production**, amounts derived as interest on loans (review scheduled for 2020); and
4) For **state-chartered credit unions**, an exemption for all gross income (the subject of a separate 2011 review).

Following enactment, the Department of Revenue (DOR) and stakeholders engaged in 30-years of administrative appeals and litigation on the first mortgage tax preference. The appeals centered on two issues: 1) what qualifies as non-transient residential property (see Exhibit 29 below), and 2) what qualifies as deductible interest (see Exhibit 30 on the following page). For the most part, subsequent rulings expanded the scope of the deduction.

Exhibit 29 – Rulings on What Qualifies as Non-Transient Residential Property

	Qualifies	Does not Qualify
1974	• Single family residences (1 to 4 units) • Apartments • Construction of residential property, including trailer park sites • Mixed residential and business property if the business use is 20% or less of the value • Permanent care nursing & convalescent homes *(reversed in 2000 court ruling)*	• Hotels • Motels • Transient apartments (less than 30 day stay) • Churches
2000		• Nursing homes and convalescent care homes *(court reversed 1974 DOR ruling)*[9]

Source: JLARC Analysis of statute, DOR rulings, and court rulings. All decisions are Department of Revenue rulings, unless noted as a court ruling.

[9] *Lacey Nursing Center v. The Department of Revenue*, 103 Wn. App. 169 (2000).

Exhibit 30 – Rulings on What Qualifies as Deductible Interest

Qualifies	Does not Qualify
1971 Interest on loans by speculative builders and land developers **1974** Discount points *(codified in 2010)* **1976** Late charges and pre-payment penalties **1981** Security interest in mobile homes *(court ruling)*[11] **1986** Interest on mortgage-backed securities	**1984** Fees for services provided by the lender (setup charges, document preparation fees, title insurance, and recording fees) *(court ruling)*[10] *(codified in 2010)*
1988 Loan origination fees which represent an interest yield adjustment *(codified in 2010)*	**1989** Gain on sale of mortgage-backed securities *(codified in 2010)* **1999** Interest retained by the lender to service a loan sold on the secondary market (*reversed in 2009 court ruling*)
2002 Advances to mortgage brokers to fund loans *(court ruling)*[12] **2009** Interest retained by the lender to service a loan sold on the secondary market *(court reversed 1999 determination) (codified and limited in 2010)*	**2000** Mortgage brokerage fees for serving as a broker between the bank making the loan and the buyer *(codified in 2010)*

Source: JLARC analysis of statute, DOR rulings, and court rulings. All decisions are Department of Revenue rulings, unless noted as a court ruling.

2009 The Washington Supreme Court held in *HomeStreet v. DOR*[13] that interest retained by the lender to service a loan sold on the secondary market qualifies for the deduction.

2010 The Legislature made three major changes in the law related to mortgage interest by:

1) Codifying many of the previous rulings on what qualifies as deductible interest (See Exhibits above);
2) Clarifying the deduction provided in the 2009 *HomeStree*t case applied to the specific circumstances of that case (i.e., to situations where the taxpayer originates the loan and where the retained service fees are based on interest paid by the borrower); and
3) Redefining the nexus required of out-of-state financial businesses in order to be liable for Washington B&O taxes ("nexus" is the connection with a state determined by physical and/or economic presence).

[10] *Aetna Finance v. Darwin*, 38 Wn. App 921 (1984).
[11] *Tacoma Savings & Loan Association v. The Department of Revenue*, No. 277826 (Pierce County Super. Ct. 1981).
[12] *Department of Revenue v. Security Pacific Bank*, 109 Wn. App. 795 (2002).
[13] *HomeStreet v. DOR*, 166 Wn.2d 444 (2009).

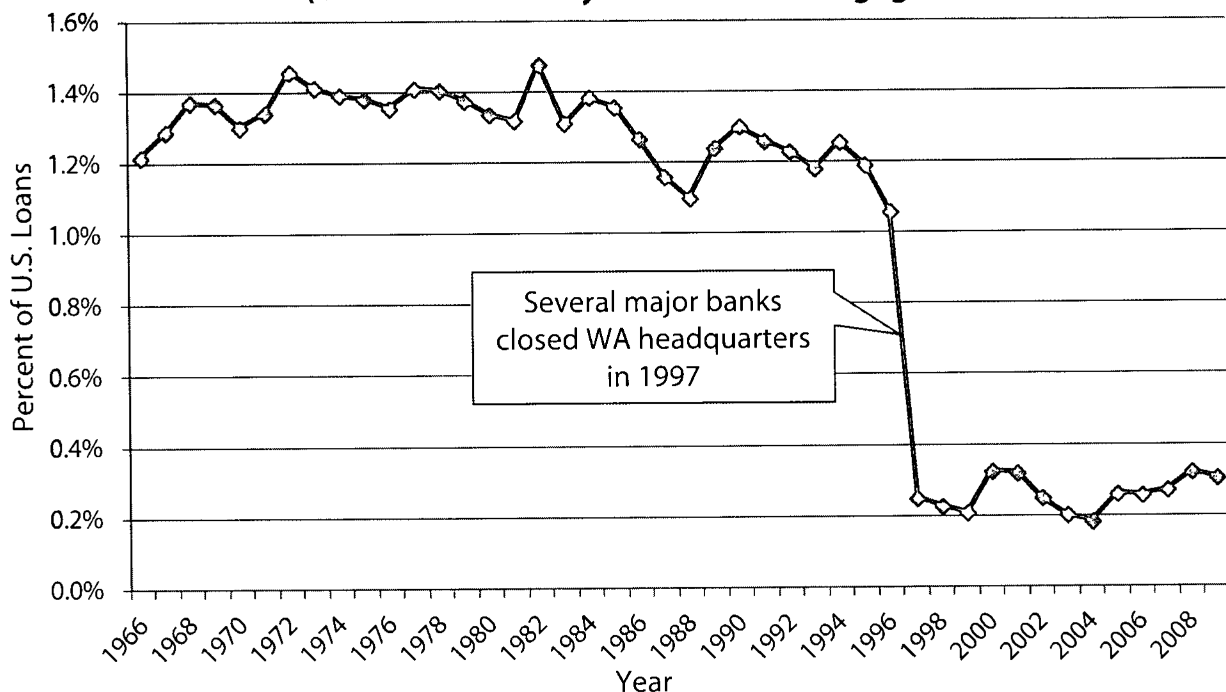
Other Relevant Background

Significant changes in the mortgage lending industry have taken place since enactment of the first mortgage deduction. A number of Washington banks have closed or merged with large multi-state banks. In addition, a secondary market for mortgage-backed securities which began building in the 1980s has developed to the point where the loan originator sells most mortgages on the secondary market.

Bank Consolidations Reduce Loans Held by Local Banks

Mortgages held in Washington have declined due to bank closures and mergers with out-of-state banks. The year 1997 signified a major decline in the amount of residential mortgage loans earning interest in Washington. In that year, several large banks closed their Washington headquarters including Bank of America, U.S. Bank of Washington, KeyBank, and First Interstate Bank of Washington.

Exhibit 31 – Percent of U.S. Loans Paying Interest to WA Banks (One to Four Family Residential Mortgages)



Source: Federal Deposit Insurance Corporation (FDIC).

Mortgage-Backed Security Market Emerges

At the time of enactment of the deduction in 1970, loan availability was highly dependent on borrowers making loan payments. Borrowers would pay interest and principal to local banks which would then use those funds to make loans to other borrowers. Now, loan availability is less dependent on local repayment of loans since most loans are quickly sold on the secondary mortgage market. Today, 87 percent of all first mortgages on home purchases in Washington are sold on the secondary market, and banks now use income from reselling the loan to finance new loans nationwide.

Short-term residential construction loans are also eligible for the deduction if the land is zoned residential and the builder commits or is required to build non-transient residential housing. Residential construction loans do not sell on the secondary mortgage market, but are retained by the originating bank.

Public Policy Objective

What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on the purpose or intent of the tax preference?

The Legislature did not state the specific public policy objective of this tax preference.

Documents from the period of enactment suggest the original purpose was to encourage Washingtonians to buy homes by making loans more available and less expensive. A letter in 1971 from the Department of Revenue to Senator Hubert Donohue, Chair or the Senate Revenue and Taxation Committee, stated that the purpose of the deduction was:

> *...to stimulate the residential housing market by making residential loans available to home buyers at lower cost.*

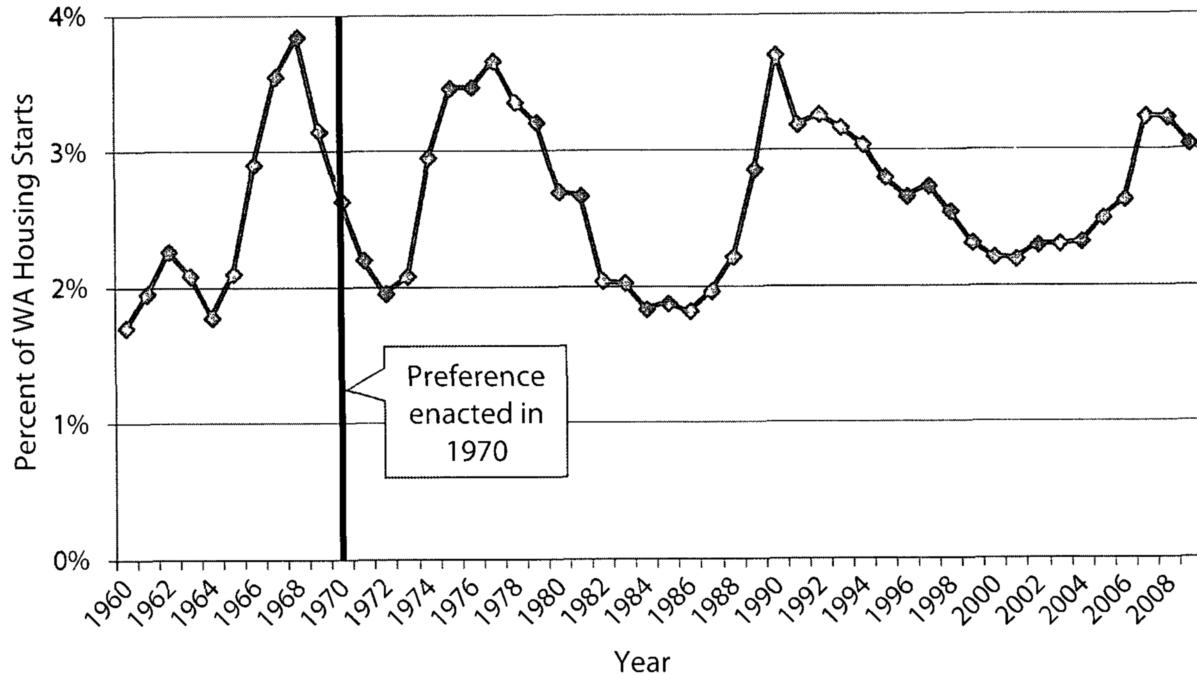
While this objective was originally articulated by DOR, it was subsequently referred to as the public policy objective by the Washington State Supreme Court in two cases, *Security Pacific v. DOR (2002)* and *HomeStreet v. DOR (2009).* When the Legislature amended the preference in response to the *HomeStreet* opinion, it did not use this opportunity to clarify the public policy objective.

What evidence exists to show that the tax preference has contributed to the achievement of any of these public policy objectives?

It is not clear from the quantitative data whether the deduction has contributed to the achievement of the implied public policy objective.

JLARC analyzed historical banking, interest rate, and homeownership data, and could find no conclusive evidence that the deduction increased loan availability or decreased loan costs in Washington. For instance, Washington housing starts, measured by new housing permits, have fluctuated considerably both before and after enactment of the preference, making it difficult to conclude whether the deduction had an effect on homeownership. See Exhibit 32, below.

Exhibit 32– Unclear if WA Housing Starts are Influenced by the Deduction (WA Housing Starts as a Percent of U.S.)



Source: JLARC analysis of U.S. Census Bureau data, 1966-2009.

On the other hand, changes in the lending industry and the economy appear to have had a significant impact on locally available loans and loan cost.

The Legislature created the deduction in an era when local banks held their own loans and used payments to fund new loans in the community. Most loans are now sold on the secondary market and do not stay in the community to generate new loans. Also, most loans in Washington are made by out-of-state owned and operated banks, and Washington loans are not dependent on local availability of funds.

To what extent will continuation of the tax preference contribute to these public policy objectives?

There is no evidence that continuation of the tax preference will contribute to the implied public policy objective of making residential loans available to Washington home buyers at lower cost.

If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?

A mortgage interest deduction for banks may no longer be an effective mechanism for achieving the implied public policy objective of increasing loan availability and decreasing loan costs in Washington. The deduction tends to benefit banks that do not sell mortgages on the secondary market. Today, the majority of banks do sell loans on the secondary market.

If the Legislature wanted to target the borrower more directly, it could structure a tax preference based on taxes paid by borrowers.

Beneficiaries

Who are the entities whose state tax liabilities are directly affected by the tax preference?

Currently, there are 111 bank and thrift institutions that make residential mortgage loans in Washington, according to banking data. An estimated 70 percent of the deduction benefits banks headquartered out of the state and 30 percent benefits banks headquartered in Washington. See Exhibit 33, below.

Exhibit 33 – Estimated Deduction Taken for First Mortgage Interest

Location of Headquarters	Interest on Loans Secured by 1st Liens	Percent of Total	Number of Banks
Out of State (estimated)	$1,842,000,000	70%	25
Washington (actual)	$787,000,000	30%	86
Total	$2,629,000,000	100%	111

Source: JLARC Estimate based on 2009 FDIC deposits and call report data. Interest income earned by out-of-state banks is not broken down by location of the loan. Instead, JLARC estimated this interest based on the percentage of Washington branch deposits to all U.S. deposits for each institution.

To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?

JLARC could find no evidence of unintended beneficiaries.

APPENDIX

D

Revenue and Economic Impacts

What are the past and future tax revenue and economic impacts of the tax preference to the taxpayer and to the government if it is continued?

The beneficiaries of the B&O tax deduction for first mortgages saved an estimated $56.6 million in state taxes in Fiscal Year 2010. Beneficiary tax savings in the two years of the 2011-2013 Biennium are estimated to be $172.6 million. (See Exhibit 34.)

Exhibit 34 – Beneficiary Tax Savings from B&O Tax Deduction for First Mortgages

Fiscal Year	Banks, Savings & Loans, Credit Unions, etc.	Mortgage Companies	Total
2009	$39,400,000	$12,600,000	$52,100,000
2010	$42,900,000	$13,700,000	$56,600,000
2011	$53,500,000	$17,100,000	$70,600,000
2012	$63,000,000	$20,100,000	$83,100,000
2013	$67,800,000	$21,700,000	$89,500,000
2011-13 Biennium	**$130,800,000**	**$41,800,000**	**$172,600,000**

Source: JLARC analysis of FDIC call and thrift reports, Federal Reserve Board Survey of Consumer Finances, DOR tax returns, and projections of U.S. home sales and prices provided by the Economic and Revenue Forecast Council.

If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from the tax preference and the extent to which the resulting higher taxes would have an effect on employment and the economy?

JLARC cannot determine the overall impact on the economy if the preference were terminated.

Termination of the tax preference would have some negative effect on the income of financial businesses that make mortgage loans in Washington. The B&O tax on a 15-year $250,000 mortgage loan at a fixed 5percent interest rate would be $225 in the first year. If the lender sold the loan, tax would only apply to the portion of interest retained for servicing the loan.

The cost of lending is determined by a wide variety of factors including the Treasury bill rate. Therefore determining the impact of the exemption on the economy is not possible.

If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?

There would be no change in the distribution of tax liability. Both in-state and out-of-state banks would pay higher B&O taxes.

ENGROSSED SENATE BILL 6635

State of Washington **62nd Legislature** **2012 2nd Special Session**

By Senators Murray and Kline

Read first time 04/04/12. Referred to Committee on Ways & Means.

1 AN ACT Relating to improving revenue and budget sustainability by
2 repealing, modifying, or revising tax preference and license fees;
3 amending RCW 82.04.4292, 82.04.4266, 82.04.4268, 82.04.4269, 82.04.260,
4 82.08.986, 82.08.986, 82.12.986, 66.24.630, 82.29A.020, 82.04.214, and
5 82.04.260; adding a new section to chapter 82.04 RCW; creating new
6 sections; providing an effective date; providing a contingent effective
7 date; providing expiration dates; and declaring an emergency.

8 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

9 **PART I**
10 **LIMITING THE FIRST INTEREST MORTGAGE B&O DEDUCTION TO COMMUNITY BANKS**

11 NEW SECTION. **Sec. 101.** A new section is added to chapter 82.04
12 RCW to read as follows:
13 (1) Amounts received as interest on loans originated by a person
14 located in more than ten states, or an affiliate of such person, and
15 primarily secured by first mortgages or trust deeds on nontransient
16 residential properties are subject to tax under RCW 82.04.290(2)(a).
17 (2) For the purposes of this subsection, a person is located in a
18 state if:

1 (a) The person or an affiliate of the person maintains a branch,
2 office, or one or more employees or representatives in the state; and
3 (b) Such in-state presence allows borrowers or potential borrowers
4 to contact the branch, office, employee, or representative concerning
5 the acquiring, negotiating, renegotiating, or restructuring of, or
6 making payments on, mortgages issued or to be issued by the person or
7 an affiliate of the person.
8 (3) For purposes of this section:
9 (a) "Affiliate" means a person is affiliated with another person,
10 and "affiliated" has the same meaning as in RCW 82.04.645; and
11 (b) "Interest" has the same meaning as in RCW 82.04.4292 and also
12 includes servicing fees described in RCW 82.04.4292(4).

13 **Sec. 102.** RCW 82.04.4292 and 2010 1st sp.s. c 23 s 301 are each
14 amended to read as follows:
15 (1) In computing tax there may be deducted from the measure of tax
16 by those engaged in banking, loan, security or other financial
17 businesses, interest received on investments or loans primarily secured
18 by first mortgages or trust deeds on nontransient residential
19 properties.
20 (2) Interest deductible under this section includes the portion of
21 fees charged to borrowers, including points and loan origination fees,
22 that is recognized over the life of the loan as an adjustment to yield
23 in the taxpayer's books and records according to generally accepted
24 accounting principles.
25 (3) Subsections (1) and (2) of this section notwithstanding, the
26 following is a nonexclusive list of items that are not deductible under
27 this section:
28 (a) Fees for specific services such as: Document preparation fees;
29 finder fees; brokerage fees; title examination fees; fees for credit
30 checks; notary fees; loan application fees; interest lock-in fees if
31 the loan is not made; servicing fees; and similar fees or amounts;
32 (b) Fees received in consideration for an agreement to make funds
33 available for a specific period of time at specified terms, commonly
34 referred to as commitment fees;
35 (c) Any other fees, or portion of a fee, that is not recognized
36 over the life of the loan as an adjustment to yield in the taxpayer's

1 books and records according to generally accepted accounting
2 principles;
3 (d) Gains on the sale of valuable rights such as service release
4 premiums, which are amounts received when servicing rights are sold;
5 and
6 (e) Gains on the sale of loans, except deferred loan origination
7 fees and points deductible under subsection (2) of this section, are
8 not to be considered part of the proceeds of sale of the loan.
9 (4) Notwithstanding subsection (3) of this section, in computing
10 tax there may be deducted from the measure of tax by those engaged in
11 banking, loan, security, or other financial businesses, amounts
12 received for servicing loans primarily secured by first mortgages or
13 trust deeds on nontransient residential properties, including such
14 loans that secure mortgage-backed or mortgage-related securities, but
15 only if:
16 (a)(i) The loans were originated by the person claiming a deduction
17 under this subsection (4) and that person either sold the loans on the
18 secondary market or securitized the loans and sold the securities on
19 the secondary market; or
20 (ii)(A) The person claiming a deduction under this subsection (4)
21 acquired the loans from the person that originated the loans through a
22 merger or acquisition of substantially all of the assets of the person
23 who originated the loans, or the person claiming a deduction under this
24 subsection (4) is affiliated with the person that originated the loans.
25 For purposes of this subsection, "affiliated" means under common
26 control. "Control" means the possession, directly or indirectly, of
27 more than fifty percent of the power to direct or cause the direction
28 of the management and policies of a person, whether through the
29 ownership of voting shares, by contract, or otherwise; and
30 (B) Either the person who originated the loans or the person
31 claiming a deduction under this subsection (4) sold the loans on the
32 secondary market or securitized the loans and sold the securities on
33 the secondary market; and
34 (b) The amounts received for servicing the loans are determined by
35 a percentage of the interest paid by the borrower and are only received
36 if the borrower makes interest payments.
37 <u>(5) The deductions provided in this section do not apply to persons</u>
38 <u>subject to tax under section 101 of this act.</u>

(6) By June 30, 2015, the joint legislative audit and review committee must review the deductions provided in this section in accordance with RCW 43.136.055 and make a recommendation as to whether the deductions should be continued without modification, modified, or terminated immediately.

PART II
EXTENDING THE B&O TAX EXEMPTION FOR FRUIT, VEGETABLE, DAIRY, AND SEAFOOD BUSINESSES

Sec. 201. RCW 82.04.4266 and 2011 c 2 s 202 (Initiative Measure No. 1107) are each amended to read as follows:

(1) This chapter does not apply to the value of products or the gross proceeds of sales derived from:

(a) Manufacturing fruits or vegetables by canning, preserving, freezing, processing, or dehydrating fresh fruits or vegetables; or

(b) Selling at wholesale fruits or vegetables manufactured by the seller by canning, preserving, freezing, processing, or dehydrating fresh fruits or vegetables and sold to purchasers who transport in the ordinary course of business the goods out of this state. A person taking an exemption under this subsection (1)(b) must keep and preserve records for the period required by RCW 82.32.070 establishing that the goods were transported by the purchaser in the ordinary course of business out of this state.

(2) A person claiming the exemption provided in this section must file a complete annual survey with the department under RCW 82.32.585.

(3) This section expires July 1, ((~~2012~~)) 2015.

Sec. 202. RCW 82.04.4268 and 2010 c 114 s 112 are each amended to read as follows:

(1) This chapter does not apply to the value of products or the gross proceeds of sales derived from:

(a) Manufacturing dairy products; or

(b) Selling manufactured dairy products to purchasers who transport in the ordinary course of business the goods out of this state. A person taking an exemption under this subsection (1)(b) must keep and preserve records for the period required by RCW 82.32.070 establishing

APPENDIX

E

1970

private carrier bus whenever but only whenever such vehicle is stopped on the highway for the purpose of receiving or discharging passengers, except:

(a) When the passengers boarding or alighting do not have to cross a highway and the bus is stopped completely off the main traveled portion of the roadway; or

(b) When the bus is stopped at an intersection or place where traffic is controlled by a traffic officer or official traffic control signal.

(3) The driver of a vehicle upon a highway divided into separate roadways as provided in RCW 46.61.150, need not stop upon meeting or passing a private carrier bus which is on a separate roadway or when upon a limited access highway and the private carrier bus is stopped in a loading zone which is a part of or adjacent to such highway and where pedestrians are not permitted to cross the roadway.

NEW SECTION. Sec. 9. This 1970 amendatory act is necessary for the immediate preservation of the public peace, health and safety the support of the state government and its existing public institutions, and shall take effect immediately.

Passed the House February 12, 1970
Passed the Senate February 12, 1970
Approved by the Governor February 20, 1970
Filed in Office of Secretary of State February 24, 1970

CHAPTER 101
[Engrossed Substitute House Bill No. 232]
TAXES--DEDUCTIONS--FINANCIAL INSTITUTIONS--
SHARES OF STOCK

AN ACT Relating to revenue and taxation; amending section 79, chapter 235, Laws of 1945 and RCW 33.28.040; amending section 82-.04.430, chapter 15, Laws of 1961 as last amended by section 11, chapter 173, Laws of 1965 ex. sess. and RCW 82.04.430; adding a new section to chapter 15, Laws of 1961 and to chapter 82.04 RCW; repealing section 82.04.400, chapter 15, Laws of 1961, section 1, chapter 136, Laws of 1963, section 8, chapter 173, Laws of 1965 ex. sess., section 1, chapter 246,

Laws of 1969 ex. sess., and RCW 82.04.400; repealing sections 84.40.270, 84.40.280, 84.40.290, 84.40.300 and 84.40.310, chapter 15, Laws of 1961 and RCW 84.40.270, 84.40.280, 84.40-.290, 84.40.300 and 84.40.310; prescribing an effective date; and declaring an emergency.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

Section 1. Section 79, chapter 235, Laws of 1945 and RCW 33-.28.040 are each amended to read as follows:

The fees herein provided for shall be in lieu of all other corporation fees, licenses, or excises for the privilege of doing business, except for business and occupation taxes imposed pursuant to chapter 82.04 RCW, notwithstanding any other provisions of this section.

Neither an association nor its members shall be taxed upon its savings accounts as property. An association shall be taxable upon its real and tangible personal property.

An association is a mutual institution for savings and neither it nor its property shall be taxed under any law which shall exempt banks or other savings institutions from taxation.

For all purposes of taxation, the assets represented by the contingent fund and other reserves (other than reserves for expenses and specific losses) of an association shall be deemed its only permanent capital and, in computing any tax, whether property, income, or excise, appropriate adjustments shall be made to give effect to the mutual nature of such association.

Sec. 2. Section 82.04.430, chapter 15, Laws of 1961 as last amended by section 11, chapter 173, Laws of 1965 ex. sess., and RCW 82.04.430 are each amended to read as follows:

In computing tax there may be deducted from the measure of tax the following items:

(1) Amounts derived by persons, other than those engaging in banking, loan, security, or other financial businesses, from investments or the use of money as such, and also amounts derived as divi-

dends by a parent from its subsidiary corporations;

(2) Amounts derived from bona fide initiation fees, dues, contributions, donations, tuition fees, charges made for operation of privately operated kindergartens, and endowment funds. This paragraph shall not be construed to exempt any person, association, or society from tax liability upon selling tangible personal property or upon providing facilities or services for which a special charge is made to members or others. Dues which are for, or graduated upon the amount of service rendered by the recipient thereof are not permitted as a deduction hereunder;

(3) The amount of cash discount actually taken by the purchaser. This deduction is not allowed in arriving at the taxable amount under the extractive or manufacturing classifications with respect to articles produced or manufactured, the reported values of which, for the purposes of this tax, have been computed according to the provisions of RCW 82.04.450;

(4) The amount of credit losses actually sustained by taxpayers whose regular books of account are kept upon an accrual basis;

(5) So much of the sale price of motor vehicle fuel as constitutes the amount of tax imposed by the state or the United States government upon the sale thereof;

(6) Amounts derived from business which the state is prohibited from taxing under the Constitution of this state or the Constitution or laws of the United States;

(7) Amounts derived by any person as compensation for the receiving, washing, sorting, and packing of fresh perishable horticultural products and the material and supplies used therein when performed for the person exempted in RCW 82.04.330, either as agent or as independent contractor;

(8) Amounts derived as compensation for services rendered or to be rendered to patients by a hospital, as defined in chapter 70.41, devoted to the care of human beings with respect to the prevention or treatment of disease, sickness, or suffering, when such hospital

is operated by the United States or any of its instrumentalities, or by the state, or any of its political subdivisions;

(9) Amounts derived as compensation for services rendered to patients by a hospital, as defined in chapter 70.41, which is operated as a nonprofit corporation, nursing homes and homes for unwed mothers operated as religious or charitable organizations, but only if no part of the net earnings received by such an institution inures directly or indirectly, to any person other than the institution entitled to deduction hereunder. In no event shall any such deduction be allowed, unless the hospital building is entitled to exemption from taxation under the property tax laws of this state;

(10) 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;

(11) By those engaged in banking, loan, security or other financial businesses, amounts derived from interest paid on all obligations of the state of Washington, its political subdivisions, and municipal corporations organized pursuant to the laws thereof.

(12) Amounts derived as interest on loans by a lending institution which is owned exclusively by its borrowers or members and which is engaged solely in the business of making loans for agricultural production.

NEW SECTION. Sec. 3. There is added to chapter 15, Laws of 1961 and to chapter 82.04 RCW a new section to read as follows:

This chapter shall not apply to the gross income of credit unions organized under the laws of this state or the United States.

NEW SECTION. Sec. 4. The following acts or parts of acts are each repealed:

(1) Section 82.04.400, chapter 15, Laws of 1961, section 1, chapter 136, Laws of 1963, section 8, chapter 173, Laws of 1965 ex. sess., section 1, chapter 246, Laws of 1969 ex. sess., and RCW 82-

.04.400;

(2) Sections 84.40.270, 84.40.280, 84.40.290, 84.40.300, and 84.40.310, chapter 15, Laws of 1961, and RCW 84.40.270, 84.40.280, 84.40.290, 84.40.300, and 84.40.310.

NEW SECTION. Sec. 5. If any provision of this act, or its application to any person or circumstance is held invalid, the remainder of the act, or the application of the provision to other persons or circumstances is not affected.

NEW SECTION. Sec. 6. This act is necessary for the immediate preservation of the public peace, health and safety, the support of the state government and its existing public institutions, and shall take effect March 1, 1970.

Passed the House February 12, 1970
Passed the Senate February 12, 1970
Approved by the Governor February 20, 1970
Filed in Office of Secretary of State February 24, 1970

CHAPTER 102
[Engrossed House Bill No. 253]
COLLEGES AND UNIVERSITIES--
STUDENT FEES--
COMMISSION ON HIGHER EDUCATION

AN ACT Relating to higher education; amending section 2, chapter 66, Laws of 1915 as last amended by section 1, chapter 181, Laws of 1963 and RCW 28.77.030; amending section 1, chapter 164, Laws of 1921 as last amended by section 1, chapter 180, Laws of 1963 and RCW 28.80.030; amending section 3, chapter 13, Laws of 1961 ex. sess. as amended by section 10, chapter 47, Laws of 1967 and RCW 28.81.080; amending section 28B.15.200, chapter 223, Laws of 1969 ex. sess. and RCW 28B.15.200; amending section 28B.15.300, chapter 223, Laws of 1969 ex. sess. and RCW 28B.15-.300; and amending section 28B.15.400, chapter 223, Laws of 1969 ex. sess. and RCW 28B.15.400; amending section 2, chapter 263, Laws of 1969 ex. sess. and RCW 28.90.110 and RCW 28B.81-.020; declaring an emergency; and providing for the expiration of sections thereof.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

1980

1980

SESSION LAWS

OF THE

STATE OF WASHINGTON

1980 REGULAR SESSION
FORTY-SIXTH LEGISLATURE

Convened January 14, 1980. Adjourned March 13, 1980.

Published at Olympia by the Statute Law Committee pursuant to Chapter 6, Laws of 1969.

DENNIS W. COOPER
Code Reviser

be brought later than April 15, 1980, or thirty days from the effective date of this act, whichever is later. Notice of provisions of this subsection shall be published within five days after the effective date of this section of this 1980 act in a newspaper of general circulation within each county where a school district election was held on February 5, 1980, and where notice of such election was not published as provided in subsection (1) of this section.

NEW SECTION. Sec. 9. Section 8 of this 1980 act is necessary for the immediate preservation of the public peace, health, and safety, the support of the state government and its existing public institutions, and shall take effect immediately.

NEW SECTION. Sec. 10. If any provision of this amendatory act or its application to any person or circumstance is held invalid, the remainder of the act or the application of the provision to other persons or circumstances is not affected.

Passed the House February 21, 1980.
Passed the Senate February 15, 1980.
Approved by the Governor February 28, 1980.
Filed in Office of Secretary of State February 28, 1980.

CHAPTER 36

[House Bill No. 277]
COMIC BOOKS

AN ACT Relating to comic books; and repealing sections 1 through 15, chapter 282, Laws of 1955 and RCW 19.18.010 through 19.18.900.

Be it enacted by the Legislature of the State of Washington:

NEW SECTION. Section 1. Sections 1 through 15, chapter 282, Laws of 1955 and RCW 19.18.010 through 19.18.900 are each repealed.

Passed the House January 14, 1980.
Passed the Senate February 18, 1980.
Approved by the Governor February 29, 1980.
Filed in Office of Secretary of State February 29, 1980.

CHAPTER 37

[Substitute House Bill No. 1016]
EXCISE TAX EXEMPTIONS, DEDUCTIONS—SECTION DIVISION, RECODIFICATION

AN ACT Relating to the recodification of existing excise tax exemptions and deductions; dividing sales tax exemptions, use tax exemptions, and business and occupation tax deductions into separate sections; amending section 82.04.425, chapter 15, Laws of 1961 as amended by section 9, chapter 173, Laws of 1965 ex. sess. and RCW 82.04.425; amending section 82.12.020, chapter 15, Laws of 1961 as last amended by section 3, chapter 324, Laws of 1977 ex. sess. and RCW 82.12.020; amending section 6, chapter 196, Laws of

1979 ex. sess. and RCW 82.04.431; adding new sections to chapter 15, Laws of 1961 and to chapter 82.04 RCW; adding new sections to chapter 15, Laws of 1961 and to chapter 82.08 RCW; adding new sections to chapter 15, Laws of 1961 and to chapter 82.12 RCW; creating a new section; repealing section 82.04.430, chapter 15, Laws of 1961, section 5, chapter 293, Laws of 1961, section 11, chapter 173, Laws of 1965 ex. sess., section 5, chapter 65, Laws of 1970 ex. sess., section 2, chapter 101, Laws of 1970 ex. sess., section 1, chapter 13, Laws of 1971, section 1, chapter 105, Laws of 1977 ex. sess., section 5, chapter 196, Laws of 1979 ex. sess. and RCW 82.04.430; repealing section 1, chapter 12, Laws of 1979, section 6, chapter 266, Laws of 1979 ex. sess. and RCW 82.08.030; repealing section 2, chapter 12, Laws of 1979, section 7, chapter 266, Laws of 1979 ex. sess. and RCW 82.12.030; and declaring an emergency.

Be it enacted by the Legislature of the State of Washington:

NEW SECTION. Section 1. The separation of sales tax exemption, use tax exemption, and business and occupation deduction sections into shorter sections is intended to improve the readability and facilitate the future amendment of these sections. This separation shall not change the meaning of any of the exemptions or deductions involved.

NEW SECTION. Sec. 2. There is added to chapter 15, Laws of 1961 and to chapter 82.04 RCW a new section to read as follows:

In computing tax there may be deducted from the measure of tax amounts derived by persons, other than those engaging in banking, loan, security, or other financial businesses, from investments or the use of money as such, and also amounts derived as dividends by a parent from its subsidiary corporations.

NEW SECTION. Sec. 3. There is added to chapter 15, Laws of 1961 and to chapter 82.04 RCW a new section to read as follows:

In computing tax there may be deducted from the measure of tax amounts derived from bona fide initiation fees, dues, contributions, donations, tuition fees, charges made for operation of privately operated kindergartens, and endowment funds. This paragraph shall not be construed to exempt any person, association, or society from tax liability upon selling tangible personal property or upon providing facilities or services for which a special charge is made to members or others. If dues are in exchange for any significant amount of goods or services rendered by the recipient thereof to members without any additional charge to the member, or if the dues are graduated upon the amount of goods or services rendered, the value of such goods or services shall not be considered as a deduction hereunder.

NEW SECTION. Sec. 4. There is added to chapter 15, Laws of 1961 and to chapter 82.04 RCW a new section to read as follows:

In computing tax there may be deducted from the measure of tax the amount of cash discount actually taken by the purchaser. This deduction is not allowed in arriving at the taxable amount under the extractive or manufacturing classifications with respect to articles produced or manufactured, the reported values of which, for the purposes of this tax, have been computed according to the provisions of RCW 82.04.450.

by such an institution inures directly or indirectly, to any person other than the institution entitled to deduction hereunder. In no event shall any such deduction be allowed, unless the hospital building is entitled to exemption from taxation under the property tax laws of this state.

NEW SECTION. Sec. 11. There is added to chapter 15, Laws of 1961 and to chapter 82.04 RCW a new section to read as follows:

In computing tax there may be deducted from the measure of tax amounts derived by a political subdivision of the state of Washington from another political subdivision of the state of Washington as compensation for services which are within the purview of RCW 82.04.290.

NEW SECTION. Sec. 12. There is added to chapter 15, Laws of 1961 and to chapter 82.04 RCW a new section to read 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.

NEW SECTION. Sec. 13. There is added to chapter 15, Laws of 1961 and to chapter 82.04 RCW a new section to read 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 paid on all obligations of the state of Washington, its political subdivisions, and municipal corporations organized pursuant to the laws thereof.

NEW SECTION. Sec. 14. There is added to chapter 15, Laws of 1961 and to chapter 82.04 RCW a new section to read as follows:

In computing tax there may be deducted from the measure of tax amounts derived as interest on loans to bona fide farmers and ranchers, producers or harvesters of aquatic products, or their cooperatives by a lending institution which is owned exclusively by its borrowers or members and which is engaged solely in the business of making loans and providing finance–related services to bona fide farmers and ranchers, producers or harvesters of aquatic products, their cooperatives, rural residents for housing, or persons engaged in furnishing farm–related or aquatic–related services to these individuals or entities.

NEW SECTION. Sec. 15. There is added to chapter 15, Laws of 1961 and to chapter 82.04 RCW a new section to read as follows:

In computing tax there may be deducted from the measure of tax by persons subject to payment of the tax on manufacturers pursuant to RCW 82.04.240, the value of articles to the extent of manufacturing activities completed outside the United States, if:

(1) Any additional processing of such articles in this state consists of minor final assembly only; and

for services taxable under RCW 82.04.290. In computing tax there may be deducted from the measure of tax amounts derived by a political subdivision of the state of Washington from another political subdivision of the state of Washington as compensation for services which are within the purview of RCW 82.04.290. [1980 c 37 § 11. Formerly RCW 82.04.430(10).]

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4292 Deductions—Interest on investments or loans secured by mortgages or deeds of trust. 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. [1980 c 37 § 12. Formerly RCW 82.04.430(11).]

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4293 Deductions—Interest on obligations of the state, its political subdivisions, and municipal corporations. 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 paid on all obligations of the state of Washington, its political subdivisions, and municipal corporations organized pursuant to the laws thereof. [1980 c 37 § 13. Formerly RCW 82.04.430(12).]

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4294 Deductions—Interest on loans to farmers and ranchers, producers or harvesters of aquatic products, or their cooperatives. In computing tax there may be deducted from the measure of tax amounts derived as interest on loans to bona fide farmers and ranchers, producers or harvesters of aquatic products, or their cooperatives by a lending institution which is owned exclusively by its borrowers or members and which is engaged solely in the business of making loans and providing finance-related services to bona fide farmers and ranchers, producers or harvesters of aquatic products, their cooperatives, rural residents for housing, or persons engaged in furnishing farm-related or aquatic-related services to these individuals or entities. [1980 c 37 § 14. Formerly RCW 82.04.430(13).]

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4295 Deductions—Manufacturing activities completed outside the United States. In computing tax there may be deducted from the measure of tax by persons subject to payment of the tax on manufacturers pursuant to RCW 82.04.240, the value of articles to the extent of manufacturing activities completed outside the United States, if:

(1) Any additional processing of such articles in this state consists of minor final assembly only; and

(2) In the case of domestic manufacture of such articles, can be and normally is done at the place of initial manufacture; and

(3) The total cost of the minor final assembly does not exceed two percent of the value of the articles; and

(4) The articles are sold and shipped outside the state. [1980 c 37 § 15. Formerly RCW 82.04.430(14).]

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4296 Deductions—Reimbursement for accommodation expenditures by funeral homes. In computing tax there may be deducted from the measure of tax that portion of amounts received by any funeral home licensed to do business in this state which is received as reimbursements for expenditures (for goods supplied or services rendered by a person not employed by or affiliated or associated with the funeral home) and advanced by such funeral home as an accommodation to the persons paying for a funeral, so long as such expenditures and advances are billed to the persons paying for the funeral at only the exact cost thereof and are separately itemized in the billing statement delivered to such persons. [1980 c 37 § 16. Formerly RCW 82.04.430(15).]

Intent—1980 c 37: See note following RCW 82.04.4281.

82.04.4297 Deductions—Compensation from public entities for health or social welfare services—Exception. In computing tax there may be deducted from the measure of tax amounts received from the United States or any instrumentality thereof or from the state of Washington or any municipal corporation or political subdivision thereof as compensation for, or to support, health or social welfare services rendered by a health or social welfare organization or by a municipal corporation or political subdivision, except deductions are not allowed under this section for amounts that are received under an employee benefit plan. [2002 c 314 § 3; 2001 2nd sp.s. c 23 § 2; 1988 c 67 § 1; 1980 c 37 § 17. Formerly RCW 82.04.430(16).]

Findings—Refund of taxes—Effective date—2002 c 314: See notes following RCW 82.04.4311.

Findings—2001 2nd sp.s. c 23: "The legislature finds that the deduction under the business and occupation tax statutes for compensation from public entities for health or social welfare services was intended to provide government with greater purchasing power when government provides financial support for the provision of health or social welfare services to benefited classes of persons. The legislature also finds that both the legislature and the United States congress have in recent years modified government-funded health care programs to encourage participation by beneficiaries in highly regulated managed care programs operated by persons who act as intermediaries between government entities and health or social welfare organizations. The legislature further finds that the objective of these changes is again to extend the purchasing power of scarce government health care resources, but that this objective would be thwarted to a significant degree if the business and occupation tax deduction were lost by health or social welfare organizations solely on account of their participation in managed care for government-funded health programs. In keeping with the original purpose of the health or social welfare deduction, it is desirable to ensure that compensation received from government sources through contractual managed care programs also be deductible." [2001 2nd sp.s. c 23 § 1.]

Effective date—2001 2nd sp.s. c 23: "This act is necessary for the immediate preservation of the public peace, health, or safety, or support of the state government and its existing public institutions, and takes effect immediately [July 13, 2001]." [2001 2nd sp.s. c 23 § 4.]

Intent—1980 c 37: See note following RCW 82.04.4281.

"Health or social welfare organization" defined for RCW 82.04.4297—Conditions for exemption—"Health or social welfare services" defined: RCW 82.04.431.

82.04.4298 Deductions—Repair, maintenance, replacement, etc., of residential structures and commonly held property—Eligible organizations. (1) In computing

2010

CERTIFICATION OF ENROLLMENT

SECOND ENGROSSED SUBSTITUTE SENATE BILL 6143

Chapter 23, Laws of 2010

61st Legislature
2010 1st Special Session

TAXES

EFFECTIVE DATE: Various

Passed by the Senate April 12, 2010
YEAS 25 NAYS 21

BRAD OWEN

President of the Senate

Passed by the House April 10, 2010
YEAS 52 NAYS 44

FRANK CHOPP

Speaker of the House of Representatives

CERTIFICATE

I, Thomas Hoemann, Secretary of the Senate of the State of Washington, do hereby certify that the attached is **SECOND ENGROSSED SUBSTITUTE SENATE BILL 6143** as passed by the Senate and the House of Representatives on the dates hereon set forth.

THOMAS HOEMANN

Secretary

Approved April 23, 2010, 1:44 p.m.

FILED

April 23, 2010

CHRISTINE GREGOIRE

Governor of the State of Washington

Secretary of State
State of Washington

exercise of the option would result in a sale as defined in RCW 82.45.010(2).

(b) The disclosure requirement in this subsection only applies to entities owning an interest in real property located in this state.

(2) This information ((~~shall~~)) must be made available to the department of revenue upon request for the purposes of tracking the transfer of the controlling interest in entities owning real property and to determine when the real estate excise tax is applicable in such cases.

(3) For the purposes of this section, "controlling interest" has the same meaning as provided in RCW 82.45.033.

PART III
Modifying the First Mortgage Deduction

Sec. 301. RCW 82.04.4292 and 1980 c 37 s 12 are each amended to read as follows:

(1) 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.

(2) Interest deductible under this section includes the portion of fees charged to borrowers, including points and loan origination fees, that is recognized over the life of the loan as an adjustment to yield in the taxpayer's books and records according to generally accepted accounting principles.

(3) Subsections (1) and (2) of this section notwithstanding, the following is a nonexclusive list of items that are not deductible under this section:

(a) Fees for specific services such as: Document preparation fees; finder fees; brokerage fees; title examination fees; fees for credit checks; notary fees; loan application fees; interest lock-in fees if the loan is not made; servicing fees; and similar fees or amounts;

(b) Fees received in consideration for an agreement to make funds available for a specific period of time at specified terms, commonly referred to as commitment fees;

1 (c) Any other fees, or portion of a fee, that is not recognized
2 over the life of the loan as an adjustment to yield in the taxpayer's
3 books and records according to generally accepted accounting
4 principles;
5 (d) Gains on the sale of valuable rights such as service release
6 premiums, which are amounts received when servicing rights are sold;
7 and
8 (e) Gains on the sale of loans, except deferred loan origination
9 fees and points deductible under subsection (2) of this section, are
10 not to be considered part of the proceeds of sale of the loan.
11 (4) Notwithstanding subsection (3) of this section, in computing
12 tax there may be deducted from the measure of tax by those engaged in
13 banking, loan, security, or other financial businesses, amounts
14 received for servicing loans primarily secured by first mortgages or
15 trust deeds on nontransient residential properties, including such
16 loans that secure mortgage-backed or mortgage-related securities, but
17 only if:
18 (a)(i) The loans were originated by the person claiming a deduction
19 under this subsection (4) and that person either sold the loans on the
20 secondary market or securitized the loans and sold the securities on
21 the secondary market; or
22 (ii)(A) The person claiming a deduction under this subsection (4)
23 acquired the loans from the person that originated the loans through a
24 merger or acquisition of substantially all of the assets of the person
25 who originated the loans, or the person claiming a deduction under this
26 subsection (4) is affiliated with the person that originated the loans.
27 For purposes of this subsection, "affiliated" means under common
28 control. "Control" means the possession, directly or indirectly, of
29 more than fifty percent of the power to direct or cause the direction
30 of the management and policies of a person, whether through the
31 ownership of voting shares, by contract, or otherwise; and
32 (B) Either the person who originated the loans or the person
33 claiming a deduction under this subsection (4) sold the loans on the
34 secondary market or securitized the loans and sold the securities on
35 the secondary market; and
36 (b) The amounts received for servicing the loans are determined by
37 a percentage of the interest paid by the borrower and are only received
38 if the borrower makes interest payments.

West's Revised Code of Washington Annotated Currentness
Title 82. Excise Taxes (Refs & Annos)
Chapter 82.04. Business and Occupation Tax (Refs & Annos)
→→ 82.04.4292. Deductions--Interest on investments or loans secured by mortgages or deeds of trust

(1) In computing tax there may be deducted from the measure of tax by those engaged in banking, loan, security or other financial businesses, interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties.

(2) Interest deductible under this section includes the portion of fees charged to borrowers, including points and loan origination fees, that is recognized over the life of the loan as an adjustment to yield in the taxpayer's books and records according to generally accepted accounting principles.

(3) Subsections (1) and (2) of this section notwithstanding, the following is a nonexclusive list of items that are not deductible under this section:

(a) Fees for specific services such as: Document preparation fees; finder fees; brokerage fees; title examination fees; fees for credit checks; notary fees; loan application fees; interest lock-in fees if the loan is not made; servicing fees; and similar fees or amounts;

(b) Fees received in consideration for an agreement to make funds available for a specific period of time at specified terms, commonly referred to as commitment fees;

(c) Any other fees, or portion of a fee, that is not recognized over the life of the loan as an adjustment to yield in the taxpayer's books and records according to generally accepted accounting principles;

(d) Gains on the sale of valuable rights such as service release premiums, which are amounts received when servicing rights are sold; and

(e) Gains on the sale of loans, except deferred loan origination fees and points deductible under subsection (2) of this section, are not to be considered part of the proceeds of sale of the loan.

(4) Notwithstanding subsection (3) of this section, in computing tax there may be deducted from the measure of tax by those engaged in banking, loan, security, or other financial businesses, amounts received for servicing loans primarily secured by first mortgages or trust deeds on nontransient residential properties, including such loans that secure mortgage-backed or mortgage-related securities, but only if:

(a)(i) The loans were originated by the person claiming a deduction under this subsection (4) and that person either sold the loans on the secondary market or securitized the loans and sold the securities on the secondary market; or

(ii)(A) The person claiming a deduction under this subsection (4) acquired the loans from the person that originated the loans through a merger or acquisition of substantially all of the assets of the person who originated the loans, or the

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person claiming a deduction under this subsection (4) is affiliated with the person that originated the loans. For purposes of this subsection, "affiliated" means under common control. "Control" means the possession, directly or indirectly, of more than fifty percent of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise; and

(B) Either the person who originated the loans or the person claiming a deduction under this subsection (4) sold the loans on the secondary market or securitized the loans and sold the securities on the secondary market; and

(b) The amounts received for servicing the loans are determined by a percentage of the interest paid by the borrower and are only received if the borrower makes interest payments.

CREDIT(S)

[2010 1st sp.s. c 23 § 301, eff. June 1, 2010; 1980 c 37 § 12. Formerly RCW 82.04.430(11).]

Current with all Legislation from the 2011 2nd Special Session and 2012 Legislation effective through May 31, 2012

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2012

CERTIFICATION OF ENROLLMENT

ENGROSSED SENATE BILL 6635

Chapter 6, Laws of 2012

62nd Legislature
2012 2nd Special Session

TAX PREFERENCES AND LICENSE FEES

EFFECTIVE DATE: Parts III and IV effective 05/02/12; Parts I, II, and V through VII effective 07/01/12; Sections 302 and 303 are contingent.

Passed by the Senate April 11, 2012
YEAS 35 NAYS 10

BRAD OWEN

President of the Senate

Passed by the House April 11, 2012
YEAS 74 NAYS 24

FRANK CHOPP

Speaker of the House of Representatives

CERTIFICATE

I, Thomas Hoemann, Secretary of the Senate of the State of Washington, do hereby certify that the attached is **ENGROSSED SENATE BILL 6635** as passed by the Senate and the House of Representatives on the dates hereon set forth.

THOMAS HOEMANN

Secretary

Approved May 2, 2012, 2:10 p.m.

FILED

May 2, 2012

CHRISTINE GREGOIRE

Governor of the State of Washington

Secretary of State
State of Washington

ENGROSSED SENATE BILL 6635

Passed Legislature - 2012 2nd Special Session

State of Washington **62nd Legislature** **2012 2nd Special Session**

By Senators Murray and Kline

Read first time 04/04/12. Referred to Committee on Ways & Means.

1 AN ACT Relating to improving revenue and budget sustainability by
2 repealing, modifying, or revising tax preference and license fees;
3 amending RCW 82.04.4292, 82.04.4266, 82.04.4268, 82.04.4269, 82.04.260,
4 82.08.986, 82.08.986, 82.12.986, 66.24.630, 82.29A.020, 82.04.214, and
5 82.04.260; adding a new section to chapter 82.04 RCW; creating new
6 sections; providing an effective date; providing a contingent effective
7 date; providing expiration dates; and declaring an emergency.

8 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

9 **PART I**

10 **LIMITING THE FIRST INTEREST MORTGAGE B&O DEDUCTION TO COMMUNITY BANKS**

11 NEW SECTION. **Sec. 101.** A new section is added to chapter 82.04
12 RCW to read as follows:
13 (1) Amounts received as interest on loans originated by a person
14 located in more than ten states, or an affiliate of such person, and
15 primarily secured by first mortgages or trust deeds on nontransient
16 residential properties are subject to tax under RCW 82.04.290(2)(a).
17 (2) For the purposes of this subsection, a person is located in a
18 state if:

1 (a) The person or an affiliate of the person maintains a branch,
2 office, or one or more employees or representatives in the state; and
3 (b) Such in-state presence allows borrowers or potential borrowers
4 to contact the branch, office, employee, or representative concerning
5 the acquiring, negotiating, renegotiating, or restructuring of, or
6 making payments on, mortgages issued or to be issued by the person or
7 an affiliate of the person.
8 (3) For purposes of this section:
9 (a) "Affiliate" means a person is affiliated with another person,
10 and "affiliated" has the same meaning as in RCW 82.04.645; and
11 (b) "Interest" has the same meaning as in RCW 82.04.4292 and also
12 includes servicing fees described in RCW 82.04.4292(4).

13 **Sec. 102.** RCW 82.04.4292 and 2010 1st sp.s. c 23 s 301 are each
14 amended to read as follows:
15 (1) In computing tax there may be deducted from the measure of tax
16 by those engaged in banking, loan, security or other financial
17 businesses, interest received on investments or loans primarily secured
18 by first mortgages or trust deeds on nontransient residential
19 properties.
20 (2) Interest deductible under this section includes the portion of
21 fees charged to borrowers, including points and loan origination fees,
22 that is recognized over the life of the loan as an adjustment to yield
23 in the taxpayer's books and records according to generally accepted
24 accounting principles.
25 (3) Subsections (1) and (2) of this section notwithstanding, the
26 following is a nonexclusive list of items that are not deductible under
27 this section:
28 (a) Fees for specific services such as: Document preparation fees;
29 finder fees; brokerage fees; title examination fees; fees for credit
30 checks; notary fees; loan application fees; interest lock-in fees if
31 the loan is not made; servicing fees; and similar fees or amounts;
32 (b) Fees received in consideration for an agreement to make funds
33 available for a specific period of time at specified terms, commonly
34 referred to as commitment fees;
35 (c) Any other fees, or portion of a fee, that is not recognized
36 over the life of the loan as an adjustment to yield in the taxpayer's

1 books and records according to generally accepted accounting
2 principles;
3 (d) Gains on the sale of valuable rights such as service release
4 premiums, which are amounts received when servicing rights are sold;
5 and
6 (e) Gains on the sale of loans, except deferred loan origination
7 fees and points deductible under subsection (2) of this section, are
8 not to be considered part of the proceeds of sale of the loan.
9 (4) Notwithstanding subsection (3) of this section, in computing
10 tax there may be deducted from the measure of tax by those engaged in
11 banking, loan, security, or other financial businesses, amounts
12 received for servicing loans primarily secured by first mortgages or
13 trust deeds on nontransient residential properties, including such
14 loans that secure mortgage-backed or mortgage-related securities, but
15 only if:
16 (a)(i) The loans were originated by the person claiming a deduction
17 under this subsection (4) and that person either sold the loans on the
18 secondary market or securitized the loans and sold the securities on
19 the secondary market; or
20 (ii)(A) The person claiming a deduction under this subsection (4)
21 acquired the loans from the person that originated the loans through a
22 merger or acquisition of substantially all of the assets of the person
23 who originated the loans, or the person claiming a deduction under this
24 subsection (4) is affiliated with the person that originated the loans.
25 For purposes of this subsection, "affiliated" means under common
26 control. "Control" means the possession, directly or indirectly, of
27 more than fifty percent of the power to direct or cause the direction
28 of the management and policies of a person, whether through the
29 ownership of voting shares, by contract, or otherwise; and
30 (B) Either the person who originated the loans or the person
31 claiming a deduction under this subsection (4) sold the loans on the
32 secondary market or securitized the loans and sold the securities on
33 the secondary market; and
34 (b) The amounts received for servicing the loans are determined by
35 a percentage of the interest paid by the borrower and are only received
36 if the borrower makes interest payments.
37 <u>(5) The deductions provided in this section do not apply to persons</u>
38 <u>subject to tax under section 101 of this act.</u>

1 (6) By June 30, 2015, the joint legislative audit and review
2 committee must review the deductions provided in this section in
3 accordance with RCW 43.136.055 and make a recommendation as to whether
4 the deductions should be continued without modification, modified, or
5 terminated immediately.

6 **PART II**

7 **EXTENDING THE B&O TAX EXEMPTION FOR FRUIT, VEGETABLE, DAIRY, AND**
8 **SEAFOOD BUSINESSES**

9 **Sec. 201.** RCW 82.04.4266 and 2011 c 2 s 202 (Initiative Measure
10 No. 1107) are each amended to read as follows:
11 (1) This chapter does not apply to the value of products or the
12 gross proceeds of sales derived from:
13 (a) Manufacturing fruits or vegetables by canning, preserving,
14 freezing, processing, or dehydrating fresh fruits or vegetables; or
15 (b) Selling at wholesale fruits or vegetables manufactured by the
16 seller by canning, preserving, freezing, processing, or dehydrating
17 fresh fruits or vegetables and sold to purchasers who transport in the
18 ordinary course of business the goods out of this state. A person
19 taking an exemption under this subsection (1)(b) must keep and preserve
20 records for the period required by RCW 82.32.070 establishing that the
21 goods were transported by the purchaser in the ordinary course of
22 business out of this state.
23 (2) A person claiming the exemption provided in this section must
24 file a complete annual survey with the department under RCW 82.32.585.
25 (3) This section expires July 1, ((~~2012~~)) 2015.

26 **Sec. 202.** RCW 82.04.4268 and 2010 c 114 s 112 are each amended to
27 read as follows:
28 (1) This chapter does not apply to the value of products or the
29 gross proceeds of sales derived from:
30 (a) Manufacturing dairy products; or
31 (b) Selling manufactured dairy products to purchasers who transport
32 in the ordinary course of business the goods out of this state. A
33 person taking an exemption under this subsection (1)(b) must keep and
34 preserve records for the period required by RCW 82.32.070 establishing

APPENDIX

F

COURT OF APPEALS
DIVISION II

10 DEC 23 PM 1:14

STATE OF WASHINGTON
BY ___
DEPUTY

NO. 40923-2-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

WELLS FARGO BANK, N.A.,

Appellant,

v.

DEPARTMENT OF REVENUE, STATE OF WASHINGTON,,

Respondent.

BRIEF OF RESPONDENT

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ORIGINAL

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B. The Trial Court Erred By Denying The Department's CR 12(B)(1) Motion To Dismiss 10

1. Wells Fargo failed to properly invoke the Court's jurisdiction under the APA. 11

2. The APA is the exclusive means of judicial review in this case. 13

C. RCW 82.32.060(4) Does Not Require The Department To Pay Interest When It Resolves A Tax Controversy By Entering Into A Closing Agreement. 18

1. A taxpayer is entitled to statutory interest on amounts paid "in excess of that properly due." 19

2. An agreement to pay a specific amount to settle a tax controversy is not equivalent to a finding or admission of a tax overpayment. 23

3. The constitutional ban on giving public money to private parties has no application to a negotiated settlement of contested taxes. 24

The administrative appeals spanned six tax periods (1996-2002) and involved a number of issues relating to collateralized mortgage deductions, bad debt deductions, and tax apportionment. CP 484-86. The administrative law judge (ALJ) assigned to the appeal, Beth Anne Kreger, held a hearing in Seattle to consider the consolidated appeal petitions.[1] CP 469. Wells Fargo was represented by its Tax Counsel, Andrew Gardner. *Id.* At the hearing, Mr. Gardner informed Ms. Kreger that Wells Fargo wished to resolve the matter by settlement. *Id.* at ¶ 3.

Wells Fargo and the Department subsequently exchanged a series of offers and counteroffers, culminating in the execution of a closing agreement.[2] CP 420-32. A closing agreement is the means authorized by statute by which the Department settles tax controversies. RCW 82.32.350. The Department uses a closing agreement to effect a "full and final settlement" of the tax controversy at issue. CP 300.

The recitals to the closing agreement set forth the refund requests at

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[1] The Department's administrative appeal proceedings are conducted "informally and in a nonadversarial, uncontested manner." WAC 458-20-100(5)(b). Notwithstanding their nominal designation, the Department's ALJs are not judges, adjudicative officers, or third-party neutrals. Rather, they are employees of the Department "trained in the interpretation of the Revenue Act and precedents established by prior rulings and court decisions." WAC 458-20-100(5). They act on behalf of the Department, not as neutral decision makers.

[2] On March 26, 2007, Wells Fargo submitted a written settlement offer with an attachment that identified a "Total Settlement Amount" of $2,470,941. CP 230. On February 15, 2008, the ALJ extended "a counteroffer proposing a total refund of $1,840,757 to settle the currently pending appeals contesting the partial denial refund requests filed for 1996-1999 and 2001-2002." CP 234. On February 20, 2008, Wells Fargo responded with a counteroffer, stating "we propose refunds for 1996-97 in the amounts of $446,835 and $807,934, respectively, and a total refund for all years in the amount of $1,997,685." CP 236.