

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

**APPELLANT CASHMERE VALLEY BANK'S  
APPENDICES TO REPLY BRIEF**

APP.	DESCRIPTION	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 <i>2011 Tax Preference Performance Reviews, Report 12-2</i> (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 <i>Wells Fargo v. Dep't of Revenue</i> , Case No. 40923-2-II	n/a

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# APPENDIX

A



# Washington Mutual

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

Collateral Report Group 1	
LOAN COUNT	174
Original Loan Count	88
Beginning Loan Count	0
Loans Added	1
Loans Prepaid-in-full	0
Loans Liquidated-in-full	0
Loans Repurchased	87
Ending Loan Count	
<b>PRINCIPAL BALANCE</b>	
Original Scheduled Principal Balance	\$29,050,792.89
Beginning Scheduled Principal Balance	\$9,697,825.04
Scheduled Principal Received or Advanced	\$198,280.07
Unscheduled Principal	\$20,198.64
Prepayments-in-full	\$22,636.99



# Washington Mutual

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

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

# 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

Chirag Shah  
November 5, 2010

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

Chirag Shah  
November 5, 2010

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,

Chirag Shah  
November 5, 2010

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?

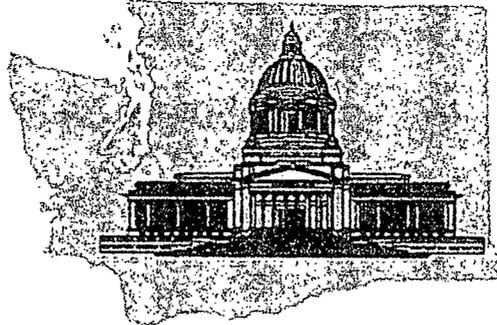
25 A The -- so the lender can do, you know, one of two

Chirag Shah  
November 5, 2010

# 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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### **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

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### **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.

Report Summary

**Summary of 2011 Tax Preference Performance Reviews**

What the Preference Does	Public Policy Objective	Estimated Beneficiary Savings	JLARC Staff Recommendation
<p><b>Interest from State and Municipal Obligations (Business &amp; Occupation Tax) / 82:04:4293</b></p> <p>Provides a B&amp;O tax deduction to financial businesses for gross income received as interest from state and municipal government obligations.</p>	<p>The Legislature did not specifically state the public policy objective of the preference.</p> <p>JLARC infers that the public policy objective is to provide consistent tax treatment for interest income from all forms of government obligations.</p>	<p>\$1.8 million in 2011-13 Biennium</p>	<p><b>Continue:</b> 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.</p> <p><i>Detail on page 85</i></p>
<p><b>Commission Comment:</b> Commission endorses the JLARC staff recommendation.</p>			
<p><b>Interest on Real Estate Loans (Business &amp; Occupation Tax) / 82:04:4292</b></p> <p>Provides a B&amp;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.</p>	<p>The Legislature did not specifically state the public policy objective of the preference.</p> <p>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.</p>	<p>\$172.6 million in 2011-13 Biennium</p>	<p><b>Review and clarify:</b> 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.</p> <p><i>Detail on page 91</i></p>
<p><b>Commission Comment:</b> 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.</p> <p><b>Rationale:</b> 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&amp;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.</p> <p>As is often the case when the B&amp;O gross receipts tax is involved in a preference, another unstated public policy purpose may be to assure competitive balance with similarly 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.</p>			

# INTEREST ON REAL ESTATE LOANS (BUSINESS & OCCUPATION TAX)

<b>Report Summary</b>			
<b>What the Preference Does</b>	<b>Public Policy Objective</b>	<b>Estimated Beneficiary Savings</b>	<b>JLARC Recommendation</b>
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	<b>Review and clarify:</b> 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)

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# INTEREST ON REAL ESTATE LOANS (BUSINESS & OCCUPATION TAX)

## Report Detail

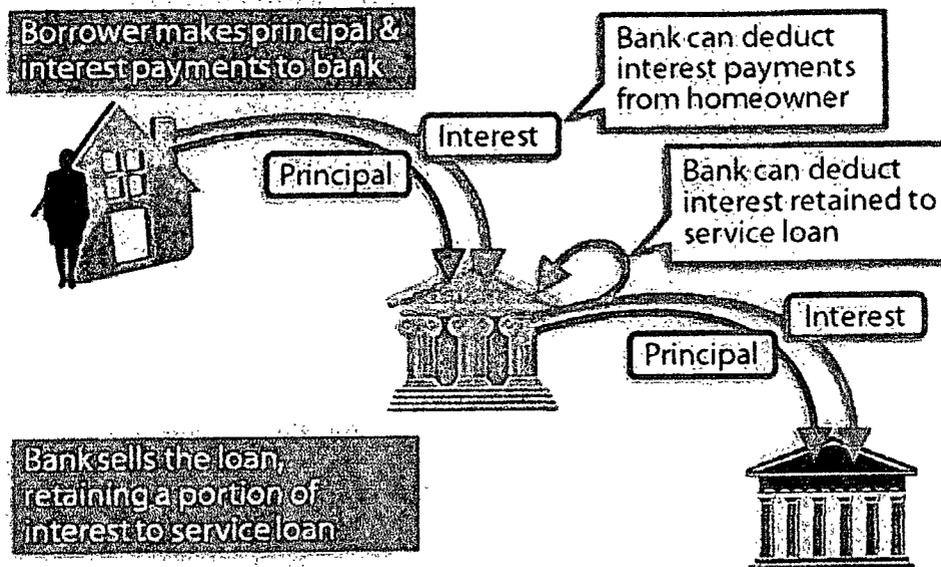
### Current Law

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.

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## Interest on Real Estate Loans (Business & Occupation Tax)

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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.<sup>6, 7, 8</sup> 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:

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<sup>6</sup> *National Bank of Commerce v. King County*, 153 Wn. 351, 1929.

<sup>7</sup> *Aberdeen Saving & Loan v. Chase*, 157 Wn. 351, June 1930.

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

Interest on Real Estate Loans (Business & Occupation Tax)

---

- 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	<ul style="list-style-type: none"> <li>• Single family residences (1 to 4 units)</li> <li>• Apartments</li> <li>• Construction of residential property, including trailer park sites</li> <li>• Mixed residential and business property if the business use is 20% or less of the value</li> <li>• Permanent care nursing &amp; convalescent homes <i>(reversed in 2000 court ruling)</i></li> </ul>	<ul style="list-style-type: none"> <li>• Hotels</li> <li>• Motels</li> <li>• Transient apartments (less than 30 day stay)</li> <li>• Churches</li> </ul>
2000		<ul style="list-style-type: none"> <li>• Nursing homes and convalescent care homes <i>(court reversed 1974 DOR ruling)</i><sup>9</sup></li> </ul>

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

<sup>9</sup> *Lacey Nursing Center v. The Department of Revenue*, 103 Wn. App. 169 (2000).

Interest on Real Estate Loans (Business & Occupation Tax)

**Exhibit 30 – Rulings on What Qualifies as Deductible Interest**

Qualifies	Does not Qualify
1971 Interest on loans by speculative builders and land developers	1984 Fees for services provided by the lender (setup charges, document preparation fees, title insurance, and recording fees) (court ruling) <sup>10</sup> (codified in 2010)
1974 Discount points (codified in 2010)	
1976 Late charges and pre-payment penalties	
1981 Security interest in mobile homes (court ruling) <sup>11</sup>	
1986 Interest on mortgage-backed securities	
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)
	2000 Mortgage brokerage fees for serving as a broker between the bank making the loan and the buyer (codified in 2010)
2002 Advances to mortgage brokers to fund loans (court ruling) <sup>12</sup>	
2009 Interest retained by the lender to service a loan sold on the secondary market (court reversed 1999 determination) (codified and limited 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*<sup>13</sup> 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 *HomeStreet* 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).

<sup>10</sup> *Aetna Finance v. Darwin*, 38 Wn. App 921 (1984).

<sup>11</sup> *Tacoma Savings & Loan Association v. The Department of Revenue*, No. 277826 (Pierce County Super. Ct. 1981).

<sup>12</sup> *Department of Revenue v. Security Pacific Bank*, 109 Wn. App. 795 (2002).

<sup>13</sup> *HomeStreet v. DOR*, 166 Wn.2d 444.(2009).

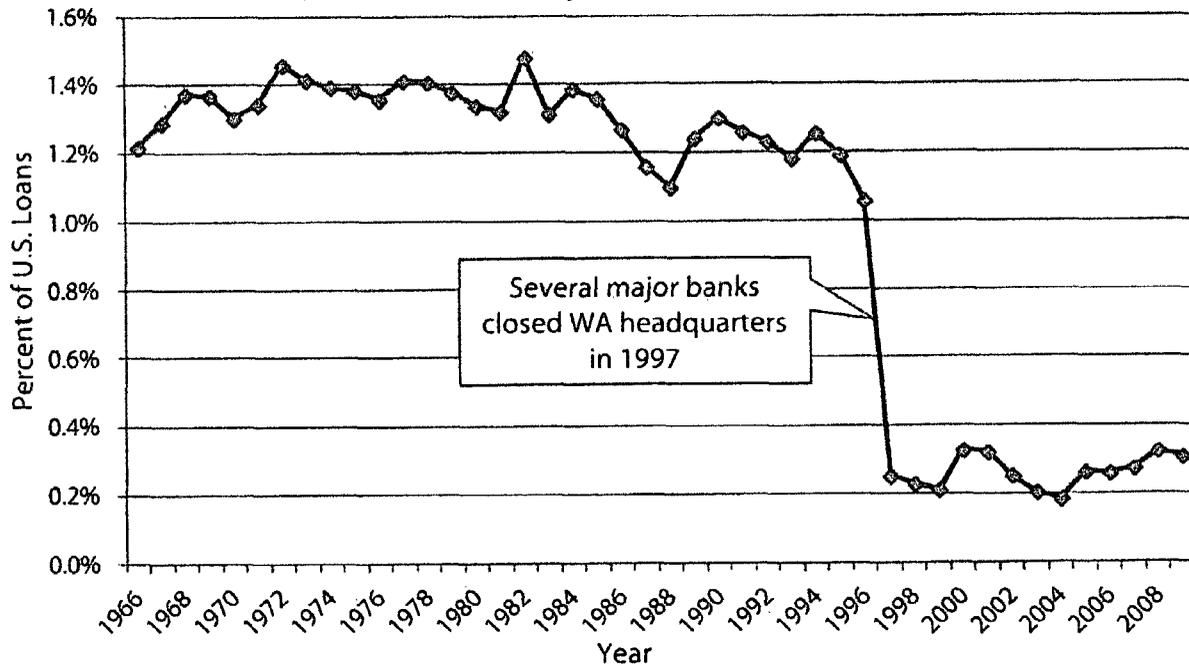
### Other Relevant Background

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 of 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.*

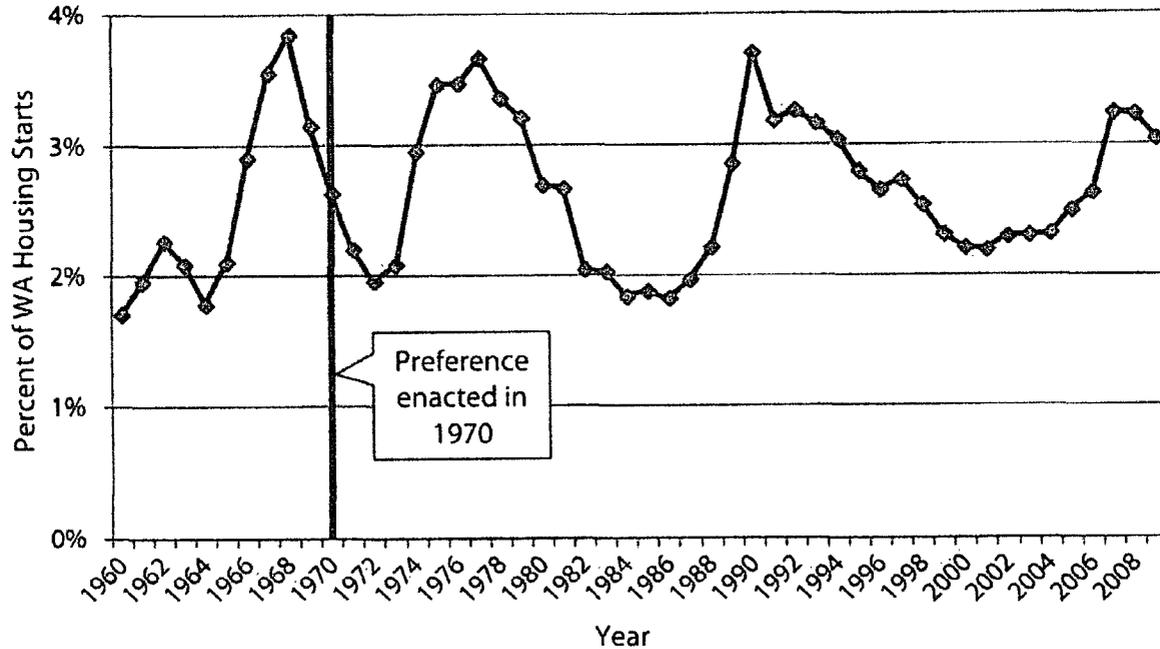
While this objective was originally articulated by DOR, it was subsequently referred to as the public policy objective by the Washington State Supreme Court in two cases, *Security Pacific v. DOR (2002)* and *HomeStreet v. DOR (2009)*. When the Legislature amended the preference in response to the *HomeStreet* 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**

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

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.

## 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**

<b>Fiscal Year</b>	<b>Banks, Savings &amp; Loans, Credit Unions, etc.</b>	<b>Mortgage Companies</b>	<b>Total</b>
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
<b>2011-13 Biennium</b>	<b>\$130,800,000</b>	<b>\$41,800,000</b>	<b>\$172,600,000</b>

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.

## **Other States**

***Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?***

Washington is the only state to offer a statewide deduction for income specifically derived from interest on loans secured by first mortgages or trust deeds. However, West Virginia has an identical deduction for municipal business and occupation taxes. Almost all other states use net income or net worth to tax financial institutions and do not provide a deduction for interest.

## **Recommendation**

**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, the Legislature should clarify the public policy objective of the first mortgage interest deduction.**

<b>Legislation Required:</b>	Yes
<b>Fiscal Impact:</b>	Depends on the legislation

# **APPENDIX**

**D**



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 (5) The deductions provided in this section do not apply to persons  
38 subject to tax under section 101 of this act.



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# 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,

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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-

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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

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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:

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**1980**

1980  
SESSION LAWS  
OF THE  
STATE OF WASHINGTON

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1980 REGULAR SESSION  
FORTY-SIXTH LEGISLATURE

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



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DENNIS W. COOPER  
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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.

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#### 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.

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#### 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

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(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

[Title 82 RCW—page 41]

**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

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

CHRISTINE GREGOIRE

Governor of the State of Washington

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

FILED

April 23, 2010

Secretary of State  
State of Washington

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

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

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

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

12 **PART III**

13 **Modifying the First Mortgage Deduction**

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

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

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

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

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

33 (b) Fees received in consideration for an agreement to make funds  
34 available for a specific period of time at specified terms, commonly  
35 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 CurrentnessTitle 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

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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END OF DOCUMENT

**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**

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

**CHRISTINE GREGOIRE**

**Governor of the State of Washington**

**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**

**FILED**

**May 2, 2012**

**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 (5) The deductions provided in this section do not apply to persons  
38 subject to tax under section 101 of this act.



# APPENDIX

F

**Errors discovered during the pre-argument due diligence check of the printed and scanned versions of Cashmere Valley's Opening Brief**

The chart below lists the errors in the printed brief copy of Appendices C to E:

APP.	DESCRIPTION
C	Excerpt from <i>2011 Tax Preference Performance Reviews, Report 12-2 (2012)</i> , pages 1, 11, 89-100: <b>Pages 99-100 missing</b>
D	Excerpt from Chapter 6, Laws of 2012: <b>Pages 99-100 from App. C found directly behind label sheet for App. D and in front of the correct pages (1-4) for App. D</b>
E	RCW 82.04.4292 and Legislative History 1970-2012: <b>First numbered page is missing entirely</b>

The chart below lists the errors in the scanned brief copy of Appendices C to E:

APP.	DESCRIPTION
C	Excerpt from <i>2011 Tax Preference Performance Reviews, Report 12-2 (2012)</i> , pages 1, 11, 89-100: <b>Pages 99-100 missing</b>
D	Excerpt from Chapter 6, Laws of 2012: <b>Page 99 from App. C found directly behind label sheet for App. D and in front of the correct pages (1-4) of App. D, page 100 from App. C is missing entirely</b>
E	RCW 82.04.4292 and Legislative History 1970-2012: <b>No pages missing in this copy</b>

FILED  
COURT OF APPEALS  
DIVISION II  
2013 FEB 26 AM 10:13  
STATE OF WASHINGTON  
BY \_\_\_\_\_  
DEPUTY

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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.<sup>1</sup> 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.<sup>2</sup> 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

---

<sup>1</sup> 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.

<sup>2</sup> 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.