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DIVISION II

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STATE OF WASHINGTON
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No. 34738-5-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

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

Appellants,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

APPELLANTS' REPLY BRIEF

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I. Summary of Argument

Rather than attempting to defend the trial court's creation of a "holder" requirement that has no statutory basis, the DOR renews its three tier argument that (1) the statutory phrase "amounts derived from interest" should be treated as surplusage and replaced with the word "interest," (2) thereby allegedly creating an ambiguity, which it argues should be resolved in the DOR's favor, and finally (3) that HomeStreet's retained interest in mortgage loans that it originated and securitized and sold on a servicing retained basis should not be considered interest. While the DOR would need to prevail on all three elements of its argument in order to impose tax, all three elements are fatally flawed. First, it is axiomatic that the Court applies the plain language of a statute and gives effect to all of the words used by the Legislature. Second, a statute is not ambiguous unless it is subject to two or more reasonable constructions. A construction that requires the Court to disregard statutory language is not reasonable and cannot create an ambiguity. Since it is undisputed that the income at issue in this case is derived from interest on residential mortgage loans originated by the taxpayer, HomeStreet qualifies for the statutory deduction as the DOR repeatedly recognized throughout the early to mid 1990s.

II. Argument

A. The Plain Language of the Statute Is Unambiguous.

Although the DOR acknowledges that the case involves a dispute regarding "the proper construction of RCW 82.04.4292 and its reference to 'amounts derived from interest'," DOR Br. at 9, most of the Department's argument is based on the erroneous premise that the statute is ambiguous. In order to create an alleged ambiguity, the DOR ignores the words "amounts derived from" as mere surplusage, with the breezy declaration that "[t]he statute is better understood as referring to persons receiving 'interest.'" DOR Br. at 12. In oral argument before the superior court, the DOR was even more explicit about its interpretation of the statute:

> THE COURT: So what is the purpose of the "derived from" language?
>
> MR. COFER: The purpose is basically meaningless. There is no purpose.

RP 28. However, the Legislature is presumed not to have used superfluous words and courts "are bound to accord meaning, if possible, to every word in a statute." *In re Marriage of Barber*, 106 Wn.App. 390, 394-395, 23 P.3d 1106 (2001). "Statutes are to be construed, wherever possible, so that no clause, sentence or word shall be superfluous, void, or insignificant." *United Parcel Service, Inc. v. Department of Revenue*, 102

Wn.2d 355, 361, 687 P.2d 186 (1984). Courts may not rewrite or delete the plain language of an unambiguous statute. *State v. Roggenkamp*, 153 Wn.2d 614, 632, 106 P.3d 196 (2005).

The ultimate question for this Court is whether the interest paid by mortgage borrowers to and retained by HomeStreet are amounts "derived from interest." The DOR does not dispute that the plain meaning of "derived" is "received from a specified source." Black's Law Dictionary 444 (6th ed. 1990). *See also, e.g.*, Webster's Third New International Dictionary 608 (1981) (defining "derive" as "to take or receive esp. from a source."); American Heritage College Dictionary 375 (3rd ed. 1997) (defining "derive" as "to obtain or receive from a source."). Rather, the DOR's own expert testified that when HomeStreet securitizes its loans or sells them with servicing rights retained, HomeStreet has retained an asset that was part of the original mortgage loan. Mr. Baldwin further testified that HomeStreet's retained interest was a derivative that is paid from interest on the underlying loan: "It is paid from interest. It's embedded as a part of it [the original mortgage loan]." CP 50 (Baldwin Dep. Transcript at 136-137).

The DOR now attempts to minimize the importance of its expert's testimony by stating that "he had no knowledge of the tax issue in this case and had no opinion about the proper taxation of HomeStreet." DOR

Br. 27. This Court does not need an expert's assistance in interpreting the plain language of the statute. While Mr. Baldwin was appropriately not opining on the law, he did testify about the operation of the secondary market and the nature of retained servicing assets and the revenues at issue in this appeal. CP 47-48 (Baldwin Dep. Transcript at 125-127). Based on extensive experience in the industry—presumably the reason the DOR hired Mr. Baldwin as an expert in the first place—Mr. Baldwin testified that HomeStreet and similar lenders retain an asset that remains subject to the same set of risks associated with the original mortgage and receive revenue that is paid from interest and derived from the original mortgage loan. CP 48-50 (Baldwin Dep. Transcript at 128-130, 136-137). Mr. Baldwin's testimony is valuable because it demonstrates factually that HomeStreet's revenue is "derived from interest."

Contrary to the DOR's suggestion, the *Security Pacific* case tells us nothing about whether the statute should be interpreted to delete the phrase "amounts derived from" from the plain language of the statute. It is well settled that a case in which a legal theory was not litigated by the parties "is not controlling on a future case when the legal theory is properly raised." *Berschauer/Phillips Const. Co. v. Seattle School Dist. No. 1*, 124 Wn.2d 816, 824, 881 P.2d 986 (1994). *Security Pacific* involved a lender who received interest income, and this Court merely

concluded that interest income was deductible under RCW 82.04.4292. *Department of Revenue v. Security Pacific Bank of Washington*, 109 Wn.App. 795, 38 P.3d 354 (2002). The Court did not say that "only interest" was deductible or that other "amounts derived from interest" were not deductible. As the DOR acknowledged in oral argument before the superior court, *Security Pacific* simply did not involve the retained interest issue present in the current case. RP at 22.

The DOR also relies on *TMS Mortgage, Inc.*, an informal[1] administrative decision by the Board of Tax Appeals ("BTA"), to support its position that HomeStreet is receiving fee income and not "interest." DOR Br. at 13. Ironically, the DOR has publicly announced that the BTA's decision in *TMS Mortgage* is wrong and will not be followed by the DOR. CP 803-804 (DOR, Excise Tax Advisory No. 2009-1S.32) ("The Department of Revenue does not acquiesce in the Board of Tax Appeals' decision in *TMS Mortgage Inc./The Money Store, Inc.* 54718 (Issued 6/26/01)").

It is ultimately this Court's responsibility to determine whether interest paid by mortgage borrowers and retained by HomeStreet are

"amounts derived from interest." This issue has not been previously addressed by the courts. Under the plain language of the statute and the undisputed facts, HomeStreet is entitled to the deduction.

B. After Attempting to Manufacture Ambiguity in the Statute, the DOR Bases its Argument on Rules of Construction That Have No Merit.

The DOR's argument depends on external sources and rules of statutory construction to narrow RCW 82.04.4292 to suit the DOR's latest interpretative epiphany. However, "[w]here statutory language is plain and unambiguous courts will not construe the statute but will glean the legislative intent from the words of the statute itself, regardless of contrary interpretation by an administrative agency." *Agrilink Foods, Inc. v. Dept. of Revenue*, 153 Wn.2d 392, 396, 103 P.3d 1226 (2005). "When words in a statute are plain and unambiguous, this Court is required to assume the Legislature meant what it said and apply the statute as written." *State ex rel. Evergreen Freedom Foundation v. Washington Education Ass'n*, 140 Wn.2d 615, 631, 999 P.2d 602 (2000). Even if it was appropriate to resort to rules of construction, the DOR's arguments do not support its conclusion.

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[1] Informal BTA appeals are not conducted pursuant to the Administrative Procedure Act, chapter 34.05 RCW and are not subject to judicial review. WAC 456-10-010.

1. The Department's interpretation of RCW 82.04.4292 has been inconsistent and cannot support a claim of legislative acquiescence.

The DOR states that HomeStreet "implies" that the DOR has inconsistently interpreted the deduction. DOR Br. 28. To the extent we were unclear, we should be explicit: The DOR has inconsistently interpreted RCW 82.04.4292.

In 1992, the DOR issued a final determination holding that Continental, Inc. and Continental Savings Bank (HomeStreet's predecessors) were entitled to deduct the same type of revenue at issue in this case. CP 147-159 (*In re Continental, Inc.,* Det. No. 92-403). In its brief, the DOR explains that they "may have misconstrued the facts in that determination" and speculates that "the Department did not have the benefit of the purchase and sale agreements, the master servicing contracts, the service and selling guides, the SEC 10-K reports, or the form MBS prospectus." DOR Br. at 29. There is nothing in the record to support this speculation, and, in fact, the DOR had access to these documents. For example, in Det. No. 92-392 the administrative law judge made express reference to "the agreements governing the assignment." CP 88.

The DOR's 1992 determination allowing the deduction to Continental/HomeStreet was not an isolated decision in which the DOR

sloppily failed to review documents. The DOR issued the determination three years into litigation with Continental on this issue. In 1989, Continental filed suit against the DOR asserting that its retained interest income was deductible as "amounts derived from interest." *Continental, Inc. and Continental Savings Bank v. Dep't of Revenue*, Thurston County Superior Court Dkt. No. 89-2-02991-7 (filed December 29, 1989). The litigation was ultimately resolved by the DOR's favorable administrative determination, Det. No. 92-403.

This was also an issue of industry-wide significance that the DOR considered carefully and addressed in a comprehensive manner. Six days *before* issuing the HomeStreet/Continental determination, the DOR decided the same issue in favor of a different taxpayer in Det. No. 92-392. CP 58-73. The day *after* the HomeStreet/Continental determination, the Department issued Det. No. 92-404, which decided this issue in favor of yet another taxpayer. CP 114-130. After issuing these determinations, the DOR made a separate decision to designate one of them (Det. No. 92-392) "precedential" pursuant to RCW 82.32.410 and published the determination as 12 Washington Tax Decisions 535. After publication, the DOR continued to apply and reaffirm the deductibility of this revenue. *See, e.g.*, CP 132-142 (Det. No. 94-158 (August 26, 1994)).

The DOR's determinations lay waste to the DOR contention that the Legislature acquiesced in "thirty-five years" of consistent DOR interpretation. Until 1999 when the DOR publicly reversed Det. No. 92-392, the Legislature would have had no hint that the DOR interpreted RCW 82.04.4292 to deny home mortgage lenders the deduction at issue. Why should it? Taxpayers were taking the deduction with the very public blessing of the DOR.

2. The legislative history does not support the DOR's position.

After finding the statutory language ambiguous, the DOR argues that the legislative history shows a "clear intent" to limit the deduction "only to interest" and not, as the statute actually says, to amounts derived from interest. DOR Br. at 15. Nowhere in the legislative history is there any evidence that the Legislature intended to limit the plain language of the deduction to "only interest." The only legislative history cited by the DOR are three documents ***prepared by the DOR*** and submitted to the Legislature while the DOR was ***opposing*** the enactment of the deduction at issue.[2] DOR Br. at 15-16. It would be strange if the Legislature's intent

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[2] One of the documents quoted by the DOR is a memorandum from the DOR director to the Chair of the Senate Subcommittee on Revenue and Taxation arguing that the deduction was unnecessary. DOR Br. at 16. The director's argument was apparently given very little weight

were divined from DOR characterizations of legislation that it unsuccessfully attempted to block rather than the plain language of the statute.

Furthermore, it is difficult to read the references to an "interest" deduction in these three DOR documents as anything more than a short-hand label for the deduction.[3] The same DOR communications also referred to the deduction as an exemption for "residential mortgage loans." CP 792. The DOR's label is presumably not "clear" legislative intent to change the plain language of the statute to (a) apply the deduction to second mortgages or (b) deny deductions related to deeds of trust. The fact that the DOR labeled this an "interest" deduction in communicating with the Legislature is scarcely sufficient basis to strike words from the statute.

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since the senator responded by promptly moving to suspend the rules and put the bill to a vote without referring it to his subcommittee. CP 767.

[3] According to the DOR's brief, the retained interest at issue in this case is "simply too small in the context of the amounts loaned [and] the interest collected" to materially impact the business of financial institutions. DOR Br. at 20. If that is the DOR's view, it should not be surprising that the DOR's submissions to the Legislature in opposition to the deduction would focus on "interest" without mentioning the interest retained when loans are sold on a servicing retained basis. It also explains why the DOR's failure to specifically mention it in its fiscal note is not "conspicuous."

The Legislature's purpose in adopting RCW 82.04.4292 was "to stimulate the residential housing market by making residential loans available to home buyers at lower cost ...." *Security Pacific*, 109 Wn.App. 795 at 804. The DOR claims that its denial of the deduction to lenders who make secondary market sales does not undermine the Legislature's purpose because the economic burden of the B&O tax on retained interest "would not create a disincentive to lenders." DOR Br. at 20. According to the DOR, "No rational lender would forgo the benefits provided by secondary market sales." *Id.* Of course, this is uninformed speculation by the DOR.[4]

C. HomeStreet's Revenue Is Derived from Interest.

The DOR goes to pains to characterize HomeStreet's retained interest as a mere fee for service. In doing so, it ignores its own expert and the undisputed evidence regarding HomeStreet's secondary market transactions.

Lenders sell loans on either a "servicing released" or "servicing retained" basis. When HomeStreet sells a loan on a servicing released basis, the purchaser begins receiving all of the principal and interest

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[4] Some very successful lenders forego secondary market sales, retain loans in their portfolios, and rely on deposits, loan repayments, and

payments attributable to the asset. CP 160 (Johnson Aff. ¶ 14). When HomeStreet sells a loan on a servicing retained basis, HomeStreet retains a portion of its original loan asset and is entitled to continue to receive a portion of the borrower's interest payments. HomeStreet receives *less money* from the investor than if HomeStreet had sold the entire loan outright without retaining a part of the original asset. CP 233 (Byers Dep. Transcript at 29); CP 197 (Byers Aff. ¶¶ 7-9); CP 160 (Johnson Aff. ¶¶ 13, 14). This price differential reflects that a purchaser is receiving more when it purchases an entire loan than it does when the originating lender retains an interest. *Id.* Stated conversely, it also reflects that a seller is retaining something of value when it sells loans on a servicing retained basis.

The amount of interest revenue retained by HomeStreet is a function of the spread between the interest received from the borrower and the interest committed to the investor and any guaranty fee paid to the guarantor. CP 511, 616. HomeStreet has flexibility in determining the amount of retained interest when it creates a mortgage backed-security. For example, HomeStreet has the option of paying the guarantor a lump sum at the outset to "buy down" the amount of guaranty fee—*i.e.*, in order

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investment income to finance their lending activities.

to reduce the guaranty fee paid by HomeStreet over the life of the security. CP 257 (Byers Dep. Transcript at 53). HomeStreet also selects the loans to be securitized, which impacts both the rate of the security and the amount of interest retained by HomeStreet. CP 220-221 (Byers Dep. Transcript at 16-17); CP 511 (Fannie Mae Servicing Guide, Part I, Ch. 2, Ex. 2).

HomeStreet's retained interest in loans that it originated is far different from fees paid to third parties that are sometimes hired to perform loan administration functions. Unlike HomeStreet's situation, lenders pay these service providers fixed fees for their services. CP 162 (Johnson Aff. ¶ 23). These fees are flat fees for service that are not connected with the size of the loan or the interest payment.[5] CP 161-162 (Johnson Aff. ¶¶ 22, 23). Unlike HomeStreet, these service providers ***do not*** have an asset. They have nothing to sell. They do not have risks associated with the loans (*e.g.*, interest rate fluctuations, default).

Also unlike a fee for service, HomeStreet's receipt of revenue is taken directly from the borrower's interest payments and is contingent on the borrower's continued payment of interest. CP 162 (Johnson Aff. ¶

24). If the borrower fails to make an interest payment, HomeStreet does not receive any revenue. *Id.* Neither the investors nor a guaranty agency pay HomeStreet a fee for service. HomeStreet's agreements with Fannie Mae and Ginnie Mae explicitly provide that HomeStreet is ***not*** entitled to receive revenue from any source other than the borrower's payment of interest. CP 509 (Fannie Mae Servicing Guide, Part I, § 203.01), CP 616 (Ginnie Mae MBS Guide, Ch. 6) (describing the "servicing fee" as "*based on and payable only from the interest portion* of each monthly installment of principal and interest *actually collected* by the issuer on the mortgage."). Furthermore, HomeStreet must make timely payments to investors even if the borrower fails to make his or her mortgage payment. *See, e.g.*, CP 579 (Ginnie Mae MBS Guide, Ch. 1, pp. 1-12, 1-13) ("[I]n case of shortfalls in collections on the mortgage loans, the issuer must supply from its own funds amounts necessary to pay the [mortgage-backed] security holders the amounts to which they are entitled on a timely basis.").

As with a loan that HomeStreet owns in its entirety, when a borrower fails to pay the interest required under the note and mortgage,

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[5] The fees are relatively small and fixed because the costs of administering loans are relatively small and are not dependent on the size

HomeStreet attempts to collect the unpaid interest from the borrower or by foreclosing the mortgage. When HomeStreet forecloses on a mortgage in which it has retained interest, HomeStreet takes its interest directly from the foreclosure sale proceeds and remits the remainder of the proceeds to the security holders or guarantor. CP 509 (Fannie Mae Servicing Guide, Part I, § 203.01). HomeStreet is able to do this because it is the mortgagee in the real property records and is legally entitled to a part of the interest secured by the real property. CP 493, 509. The DOR is simply wrong in stating that HomeStreet's interest is not secured by the real property of the borrower. *See* DOR Br. at 14.

In contrast to a mere fee for service arrangement, there is no dispute that HomeStreet's retained interest asset arises from and is embedded in every mortgage loan that HomeStreet originates. CP 50 (Baldwin Dep. Transcript at 136-137). When a mortgage loan is originated and retained in whole, "'the mortgage servicing rights remain an undivided feature of the mortgage loan." DOR Br. at 25. As the DOR states, "the servicing right was stripped from the loans when HomeStreet sold the mortgage loans to [investors]." *Id.* In other words, on origination, HomeStreet owns one asset—a mortgage loan receivable.

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of the loan. CP 161-162 (Johnson Aff. ¶¶ 22, 23).

When HomeStreet sells the receivable with servicing retained, the single loan asset is split into two parts, one of which is retained by HomeStreet.

The DOR does not dispute that the retained interest is an asset, that the asset has value, or that the asset can be sold or pledged to others. DOR Br. at 25. The undisputed evidence demonstrates that the value of the asset fluctuates in response to the same factors that cause portfolio loans to fluctuate (*i.e.*, interest rate changes, risk of prepayment, risk of default). CP 48-49 (Baldwin Dep. Transcript at 129 – 130); CP 193-194 (van Amen Aff. ¶¶ 10, 13-14). Because the value of the retained interest asset fluctuates, HomeStreet is required by Generally Accepted Accounting Principles ("GAAP") to regularly evaluate and adjust the book value of its retained interest assets to reflect their changing market value. CP 193 (van Amen Aff. ¶ 12). HomeStreet's retained interest is not a fee for service, but revenue from a valuable asset, which is embedded in every loan and retained by HomeStreet.

If HomeStreet were merely receiving a fee for service as argued by the DOR, it would not have an asset to sell or pledge. An asset only exists when the rights to income exceed the value of the obligations. If HomeStreet merely contracted to perform a service in the future for a fee, there would be no asset. That is not the case here. A lawyer or other service provider does not have an asset simply because a client has agreed

to pay a fee for future services. Unlike a fee for service arrangement, neither the investor nor guaranty agency is able to simply fire HomeStreet and hire a third party servicer. Fannie Mae cannot terminate HomeStreet's retained interest asset. At most, Fannie Mae can force HomeStreet to sell its retained interest asset to Fannie Mae or another Fannie Mae approved lender. CP 801-802 (Fannie Mae Servicing Guide, Part I, § 201.08)).

III. Conclusion

HomeStreet's retained interest asset was embedded in the mortgage loans that HomeStreet originated. When HomeStreet sold loans with servicing retained, it retained a part of original loan that included the right to receive a portion of the interest paid by the borrower. HomeStreet's revenue is received only from interest payments made by borrowers or, if the borrower fails to make the required interest payment, from the proceeds of a foreclosure sale of the secured property. Under the plain language of RCW 82.04.4292, HomeStreet's revenue at issue is "amounts derived from interest." Accordingly, appellants HomeStreet, Inc., HomeStreet Capital Corporation, and HomeStreet Bank respectfully request that the Court reverse the decision of the Thurston County Superior Court and remand the case for entry of judgment in favor of appellants refunding $20,225 in B&O tax paid for the period January 1, 2003 through January 31, 2003, plus statutory interest.

DATED: October 9, 2006.

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CERTIFICATE OF SERVICE

The undersigned certifies that a copy of the *Reply Brief of Appellants* was served upon attorneys for the respondent via first-class U.S. Mail at the following address:

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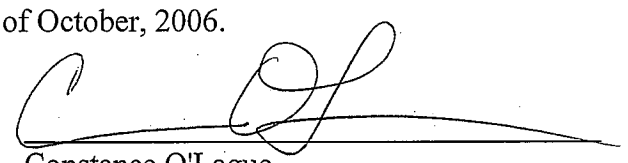

Constance O'Lague