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COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

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

Appellants,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

BRIEF OF RESPONDENT

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I. RESTATEMENT OF ISSUES PERTAINING TO APPELLANT'S ASSIGNMENTS OF ERROR

RCW 82.04.4292 provides for a deduction from the business and occupation tax:

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.

May HomeStreet, Inc., and its affiliate corporations deduct as interest, contractual fees received for performing services for mortgage loan owners?

II. COUNTERSTATEMENT OF THE CASE

A. Overview.

Washington imposes a business and occupation tax on virtually all business activities conducted within the state.¹ The Legislature, however, allows certain narrow deductions from the business and occupation ("B&O") tax. At issue is whether fees received for performing services are deductible as interest under RCW 82.04.4292, an exemption that allows the deduction of "amounts derived from interest received on investments or loans primarily secured by first mortgages or deeds of trust"

¹ RCW 82.04.220; RCW 82.04.140; *Simpson Inv. Corp., v. Dep't of Revenue*, 141 Wn. 2d 139, 149, 3 P.3d 741 (2000).

The fees at issue are servicing fees. The Appellants received servicing fees for collecting loan payments and otherwise administering mortgage loans. HomeStreet, Inc., and HomeStreet Bank (collectively referred to as “HomeStreet” “HomeStreet Bank”) originated mortgage loans and then sold the loans to new owners through the secondary market.² Upon sale, HomeStreet Bank agreed to collect mortgage payments and administer the loans for the owners.³ As compensation for the services performed, the owners paid HomeStreet Bank a servicing fee that HomeStreet Bank withheld from the interest portion of borrower payments.⁴

HomeStreet Bank claims that because the loan owners paid servicing fees from the interest portion of borrower payments, HomeStreet Bank’s fees are “retained interest” qualifying for the mortgage interest deduction under RCW 82.04.4292.⁵ The Department of Revenue (“Department”) disputes HomeStreet Bank’s characterization of its fees and contends that HomeStreet Bank is not entitled to the RCW 82.04.4292 mortgage interest deduction, a deduction limited to interest received by owners of first mortgage loans.

² HomeStreet Capital Corporation, unlike HomeStreet Bank and HomeStreet, Inc., did not originate or sell mortgage loans. The loans were originated by HomeStreet Bank who then sold HomeStreet Capital Corporation the right to service the first mortgage loans. Clerk’s Papers (“CP”) 299-300.

³ CP 369-394, 492-494.

⁴ CP 379, 508-512.

⁵ Brief of Appellants at 12-18.

Because servicing fees are a creature of contract, understanding the issue requires an understanding of the contracts as well as the secondary marketing of loans.

B. Factual Background.

The secondary marketing of mortgage loans involves originating lenders selling secured loans to replenish lending funds. HomeStreet Bank originates first mortgage loans that it sells to the Federal National Mortgage Association (“Fannie Mae”) and others⁶ on either a whole loan basis or as securitized sales.⁷ Whole loan sales to Fannie Mae are essentially cash sales of loans in which Fannie Mae pays HomeStreet Bank cash for loans and then generally keeps the loans in its loan portfolio.⁸ The terms of sale require that HomeStreet Bank transfer all its interests in the mortgage loans to Fannie Mae as well as the original mortgage notes and other loan documents.⁹

Securitized sales of first mortgage loans involve Fannie Mae purchasing pools of loans through its credit guaranty operations.¹⁰ As part

⁶ CP 161, 293, 301, 307. HomeStreet Bank also sells loans to Ginnie Mae (Government National Mortgage Association), the Oregon Housing Authority, and the Federal Home Loan Bank. CP 307. HomeStreet, Inc. sold loans to some of these entities as well as Mellon Mortgage, Bank of America, CUNA Mutual, Interwest Savings and Home Capital Collateral. CP 293. The Appellants’ contractual relationship with each entity differs slightly depending on the contract terms. CP 568-689. Because Appellants sold more than sixty percent of their loans to Fannie Mae and the Brief of Appellants limits its discussion to Fannie Mae, we also limit our discussion to Fannie Mae. A discussion of the terms of contracts with other buyers of Appellants’ loans are found at CP 759-761.

⁷ CP 314, 343.

⁸ CP 349 (diagram), 343, 422.

⁹ *E.g.* CP 295, 302, 309, 364, 371, 377, 422.

¹⁰ CP 215-216, 343, 352.

of these transactions, HomeStreet Bank places first mortgage loans with similar features and a defined range of interest rates into loan pools for sale to Fannie Mae.¹¹ Upon transfer, Fannie Mae puts the loans into a trust with Fannie Mae as trustee and the trust assuming legal ownership of the first mortgage loans.¹² In exchange for the pooled loans, Fannie Mae delivers to HomeStreet Bank certificates called mortgage backed securities or MBS's.¹³ HomeStreet Bank sells the certificates in the secondary market to replenish its lending funds.¹⁴

The swapping of the MBS certificates for the pooled first mortgage loans, like whole loan sales, are absolute sales of all HomeStreet Bank's ownership interests in the mortgage loans:

Both the lender and Fannie Mae intend for all MBS pool deliveries to Fannie Mae to be an absolute sale. By submitting a mortgage (or a participating interest in a mortgage) to us as an MBS pool delivery, the lender agrees that all of its right, title, and interest in the mortgage is sold, transferred, set over, and otherwise conveyed to Fannie Mae as of the date of our delivery of mortgage-backed securities with respect to the purchase of the MBS (which is effective as of the issue date of the related pool).¹⁵

The holder of an MBS certificate thus obtains an undivided beneficial ownership interest in each of the mortgage loans in the Fannie Mae trust.¹⁶ The certificate holder is paid a guaranteed rate of interest less than the interest rates on the underlying mortgage loans in the pool.¹⁷ The

¹¹ CP 215-216, 352.

¹² CP 352.

¹³ CP 352, 216.

¹⁴ CP 216, 352.

¹⁵ CP 425 (emphasis added), 426, 428.

¹⁶ CP 353, 434.

¹⁷ CP 351-353.

lower interest rate reflects the payment of fees associated with administering and guaranteeing the pool of loans backing the mortgage-backed securities.¹⁸

The fees paid by MBS certificate holders include Fannie Mae's guaranty fee.¹⁹ The guaranty fee is a fee charged by Fannie Mae to guarantee the timely payment of principal and interest in the event of a default by the borrower.²⁰ With payment of the guaranty fee, Fannie Mae "assumes[s] the credit risk of borrowers' defaults on the underlying mortgage loans, as well as any risk arising from a default or bankruptcy of the seller and servicer of the loans."²¹

Fannie Mae also assumes responsibility to service the loans it purchases.²² Fannie Mae contracts its servicing responsibility to HomeStreet Bank and pays HomeStreet a servicing fee for administering the loans on Fannie Mae's behalf.²³ The servicing fee is paid to reimburse HomeStreet Bank for its fiduciary duties in collecting principal and interest payments from the borrower and remitting the payments to the owner.²⁴ Some of HomeStreet's servicing responsibilities include (1)

¹⁸ CP 352.

¹⁹ CP 352-353.

²⁰ CP 352-353. HomeStreet states that it pays the guaranty fee. Brief of Appellants at 5. This statement is contrary to Fannie Mae's interpretation of its contracts. Fannie Mae retains the interest collected to pay its guaranty fee and seeks reimbursement for its fee from the MBS trust. CP 464. The MBS certificate holders can deduct these fees from the MBS income they receive when reporting their federal income taxes. CP 465-466. The MBS trust and the certificate holders pay the fee, not HomeStreet Bank.

²¹ CP 353.

²² CP 347, 453, 463.

²³ CP 437, 453, 463.

²⁴ CP 514 (servicer acts as fiduciary).

paying property taxes; (2) maintaining hazard insurance; (3) maintaining accounts for the deposit of borrower funds; (4) responding to inquiries; and (5) collecting and remitting any and all amounts due from borrowers.²⁵

To effectuate the sale of the first mortgage loans, Fannie Mae holds an unrecorded blanket assignment executed by HomeStreet Bank.²⁶ Not recording the assignment ensures that HomeStreet Bank continues to appear in the land records for the purpose of receiving legal notices of foreclosure or tax liens that impact the owners' interests.²⁷ Like a whole loan sale, however, the original mortgage notes belong to Fannie Mae with HomeStreet Bank often holding the notes as an approved custodian of Fannie Mae's documents.²⁸

To compensate HomeStreet Bank for performing its duties as a servicer, Fannie Mae pays HomeStreet Bank a fee from the interest that Fannie Mae collects each month.²⁹ During the tax period at issue, HomeStreet Bank was paid a servicing fee that varied depending on the types of loans delivered to Fannie Mae.³⁰ Servicing compensation was generally 0.25 percent (25 basis points) of the outstanding mortgage loan balance.³¹

²⁵ CP 492.

²⁶ CP 454; *see* CP 374.

²⁷ CP 454, 493. Fannie Mae retains the right to record the mortgage assignment if need arises.

²⁸ CP 309.

²⁹ CP 508, 512.

³⁰ CP 511.

³¹ CP 508-509, 511-512.

C. Procedural Background.

The genesis of this litigation dates back to the 1980's. Prior to 1990, HomeStreet Bank and HomeStreet, Inc.'s predecessors, Continental Savings Bank and Continental, Inc., (collectively referred to as "Continental") paid B&O taxes on fee income.³² In 1989, Continental filed a refund request with the Department of Revenue ("Department").³³ It sought to deduct under RCW 82.04.4292 amounts that it claimed were "retained interest." In 1992, the Department granted Continental's refund request in unpublished Determination No. 92-403. The refund request was granted because the Department believed that Continental only partially assigned its rights in the mortgage loans.³⁴ Because a partial assignment occurred, the Department determined that Continental held a beneficial legal interest in the underlying loans.³⁵

Servicing fee income became an issue between the Appellants ("HomeStreet Bank") and the Department in the mid-1990's.³⁶ By 1995, the Audit Division of the Department issued reporting instructions to HomeStreet Bank, instructing them to report and to pay B&O tax on their servicing fee income.³⁷

The Department reaffirmed its position on servicing fee income in a published determination in 1999.³⁸ In Determination No. 98-218, 18

³² See CP 148-149.

³³ *Id.*

³⁴ CP 152-154.

³⁵ *Id.*

³⁶ CP 817.

³⁷ *Id.*

³⁸ CP 94-112.

WTD 46 (1999), the Department held that fees received for the performance of specific services are not entitled to a first mortgage interest deduction.³⁹

In 2002, the Department again discovered that HomeStreet Bank had continued to take first mortgage interest deductions for servicing fee income despite prior reporting instructions.⁴⁰ After the Department assessed taxes on the servicing fee income, the parties negotiated a closing agreement for the tax period January 1, 1997 through December 31, 2001, reserving HomeStreet Bank's rights to seek a refund of future taxes paid.⁴¹

HomeStreet Bank subsequently paid one month of taxes related to its servicing fee income and filed a refund action in Thurston County Superior Court.⁴² Upon HomeStreet's motion, the superior court granted summary judgment to the Department, stating that HomeStreet Bank's "creative approach" did not provide a bright line rule or certainty for those structuring business transactions.⁴³ Thus, the superior court held that the first mortgage interest deduction was a deduction benefiting owners of mortgage loans and not third parties who receive servicing fees.⁴⁴

HomeStreet Bank filed this timely appeal, arguing that its contractual fees for services are deductible from gross income under the

³⁹ CP 103-106.

⁴⁰ CP 816-817.

⁴¹ *Id.*

⁴² CP 4-7.

⁴³ RP at 52.

⁴⁴ CP 836-838.

mortgage interest deduction of RCW 82.04.4292 because HomeStreet Bank receives its fees from the interest portion of borrower loan payments.

III. SUMMARY OF ARGUMENT

HomeStreet Bank and the Department contest the proper construction of RCW 82.04.4292 and its reference to “amounts derived from interest received on” loans secured primarily by a first mortgage.

This Court should construe the first mortgage interest deduction as a deduction limited to interest paid to an owner or beneficial owner of a secured first mortgage loan. The statute has been interpreted as an “interest income” deduction by this Court and administrative agencies. Legislative history also confirms that the deduction was intended to be an interest deduction and not a fee deduction. The Legislature’s acquiescence in the Department’s construction of RCW 82.04.4292 for over thirty-five years confirms that the deduction was intended to be an interest deduction and not a deduction for fees. To further the legislative intent, this Court should limit the mortgage interest deduction to interest and not include servicing fees within the scope of the deduction.

HomeStreet Bank’s servicing fees, moreover, are not deductible under the mortgage interest deduction as interest or “retained interest.” HomeStreet Bank does not receive interest. It receives contractual servicing fees. It retained no rights in the loans or rights in any “asset”

that could be construed as a “retained interest.” It receives a fee paid for performing services. Fee income is not deductible under the first mortgage interest deduction.

Finally, HomeStreet Bank is not entitled to a mortgage interest deduction under the Department’s published determinations. The Department has consistently allowed only those holding a beneficial ownership interest in the secured loans a deduction under RCW 82.04.4292. HomeStreet holds no such beneficial ownership interest. Thus, it is not entitled to a mortgage interest deduction.

This Court should, therefore, affirm the superior court and deny HomeStreet Bank an interest deduction for its servicing fee income.

IV. ARGUMENT

A. The Mortgage Interest Deduction In RCW 82.04.4292 Is Limited To Interest From A Secured Investment Or Loan And Is Not A Deduction For Contractual Fees For Services.

HomeStreet Bank’s servicing fee income is not deductible under the mortgage interest deduction. The statute provides an interest deduction and not a deduction for servicing fees. This is the interpretation given the deduction by this Court, administrative agencies and the Legislature. This Court, consequently, must reject HomeStreet Bank’s interpretation of the mortgage interest deduction and affirm the superior court’s order granting summary judgment to the Department.

1. RCW 82.04.4292 allows a deduction only for interest received on investments or loans secured by first mortgages or deeds of trust.

Prior to 1970, the Legislature exempted banks from the business and occupation tax under former RCW 82.04.400.⁴⁵ The Legislature repealed the exemption immediately after Congress authorized states to impose nondiscriminatory gross receipts taxes on national banks.⁴⁶ As part of this 1970 legislation, the Legislature enacted a deduction for first mortgage interest income, now codified as RCW 82.04.4292.⁴⁷ The statute allows a business and occupation (“B&O”) tax deduction for interest received on loans primarily secured by first mortgages on residential properties:

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.

The first mortgage interest deduction contains two primary requirements. First, the amounts to be deducted must be “amounts derived from interest received on investments or loans primarily secured by first mortgages or deeds of trust.” Second, the first mortgages and deeds of trust must be for nontransient residential properties.

⁴⁵ Laws of 1937, ch. 227 § 4 (enacting former RCW 82.04.400).

⁴⁶ Laws of 1970, Ex. Sess., ch. 101, § 2; See Act of Dec. 24, 1969, Pub. L. No. 91-156, 83 Stat. 434; *Chase Manhattan Bank v. Finance Admin of the City of New York*, 440 U.S. 447 (1979).

⁴⁷ Laws of 1970, Ex. Sess., ch. 101, § 2.

The Department does not dispute that the mortgages HomeStreet sold in the secondary market were first mortgages on nontransient residential properties. At dispute in this litigation is whether contractual servicing fees that HomeStreet Bank seeks to deduct are “amounts derived from interest received on investments or loans primarily secured by first mortgages.”

HomeStreet argues that its servicing fees are deductible under RCW 82.04.4292 as “amounts derived from interest.”⁴⁸ It contends that the meaning of the first mortgage interest deduction is plain on its face and extends to contractual servicing fees paid from interest.⁴⁹

HomeStreet’s construction of the first mortgage interest deduction, however, is contrary to the interpretation adopted by this Court and the Board of Tax Appeals. The statute is better understood as referring to persons receiving “interest.”

In *Department of Revenue v. Security Pacific Bank of Washington*, this Court construed RCW 82.04.4292 as an “interest deduction.”⁵⁰ The purpose of the statute was to make residential loans available to borrowers “at lower cost through the vehicle of a B&O tax [deduction] on *interest income* received by home mortgage lenders.”⁵¹ It was clear to the Court from the language and the statutory purpose that the deduction extended

⁴⁸ Brief of Appellants at 13-17.

⁴⁹ *Id.*

⁵⁰ 109 Wn. App. 795, 804, 38 P.3d 354 (2002).

⁵¹ *Id.* (emphasis added).

only to interest. This Court thus interpreted the scope of the deduction to apply to interest received by a legal or beneficial owner of a loan.⁵²

The Board of Tax Appeals (“Board”) also limited the first mortgage interest deduction to interest received by a legal or beneficial owner of a loan.⁵³ In *TMS Mortgage, Inc. v. Department of Revenue*, the Board stated that the statute allows a deduction for interest income and not fee income.⁵⁴

To the extent that the Taxpayer received any amount attributable to its agreements with the purchasers of the regular certificates, including a right to retain a stated portion of the interest on the original loan in return for undertaking to perform a service for the holders of the regular interests, it is not entitled to the residential first mortgage deduction. Thus, in this case, the 0.25 percent Servicing Fee and the 0.25 percent Contingency Fee and reimbursements for insurance costs are not deductible as “interest,” even though the Taxpayer may deduct these amounts from the interest portion of the payment made by the borrower before transferring to the trustee the principal and interest payments due the holder of the regular interests.⁵⁵

This Court’s and the Board of Tax Appeals’ interpretation is consistent with the deduction’s ordinary meaning that “derived from interest” means the taxpayer must “receive” interest.

Under the ordinary meaning of the deduction, HomeStreet Bank’s servicing fees are not amounts “derived from interest received on” a secured investment or loan that is “primarily secured by” a first mortgage.

⁵² *Id.*

⁵³ *TMS Mortgage, Inc.*, BTA No. 54718, 2001 WL 920754.

⁵⁴ *Id.*; accord AGO 2005 No. 10 (interest for purposes of RCW 82.04.4292 does not include amounts paid for services).

⁵⁵ *Id.* at 7. The Department issued a notice of non-acquiescence in the Board of Tax Appeals’ holding.

HomeStreet Bank's fees are "derived from" its servicing contract.⁵⁶ It sold all its legal and beneficial interest in the secured loans to Fannie Mae.⁵⁷ As part of the sale, HomeStreet Bank contracted to service the loans for Fannie Mae and to perform the servicing duties identified in its contract.⁵⁸ It is the servicing contract that generates its income and not the secured loans. HomeStreet's servicing fees thus are not "amounts derived from interest received on" a secured investment or loan.

HomeStreet's servicing contract is nothing more than an unsecured contract. "[T]he servicer does not have an interest in the land or in the mortgage itself."⁵⁹ The servicing contract, thus, is not secured by any lien against any real property of the borrower.⁶⁰ Lacking a security interest, HomeStreet Bank's servicing fees cannot be "received on investments or loans primarily secured by mortgages" as the statute requires. Its contractually based servicing fees simply do not fit within the scope of the first mortgage interest deduction.

HomeStreet Bank, on the other hand, sees ambiguity in the word "derive." It looks at the words in the statute in isolation, turning to the dictionary definition of "derive" to claim that servicing fees deducted from

⁵⁶ CP 496, 422, 425, 493, 497; *Huntington Mortgage Co. v. DeBrotta*, 703 N.E.2d 160, 163 n.1 (Ind. App. 1998) (loans are owned by Fannie Mae).

⁵⁷ CP 496, e.g. CP 422, 425, 493, 497.

⁵⁸ CP 347, 453, 463; E.g., *Deerman v. Federal Home Loan Mortgage Corp.*, 955 F. Supp. 1393, 1404 (N.D. Ala. 1977) (Seller/Servicer Guide is a contract between Federal Home Loan Mortgage Corporation and servicer).

⁵⁹ Karen P. Gelernt, *Secondary Market Residential Mortgage Transactions*, ¶ 9.02[3] at 9-4 (rev. 2004).

⁶⁰ Karen P. Gelernt, *Secondary Market Residential Mortgage Transactions*, ¶ 9.02[3] at 9-4.

interest are entitled to the tax deduction.⁶¹ If HomeStreet's interpretation of the statute is reasonable, the statute is now susceptible to two reasonable interpretations, one as interpreted by the Department and this Court, and another as interpreted by HomeStreet. When language in a statute is susceptible to two or more interpretations, the meaning of the statute is ambiguous.⁶² Such ambiguity cannot be resolved under a plain meaning analysis as HomeStreet contends.

2. The Legislature intended that the first mortgage interest deduction extend only to interest received on secured investments or loans.

The goal in construing a statute is to carry out the intent of the Legislature.⁶³ The legislative history of the first mortgage interest deduction shows a clear intent to extend the deduction only to interest and not to other sources of income.⁶⁴ Fiscal notes, reports, letters and explanatory history reflect that the scope of the deduction was for interest and not for contractual fees paid from interest.

When the deduction was created in early 1970 as part of Engrossed Substitute House Bill 232,⁶⁵ the Department of Revenue produced a fiscal

⁶¹ Brief of Appellants at 16.

⁶² *Lacey Nursing Ctr. Inc., v. Dep't of Revenue*, 103 Wn. App. 169, 175, 11 P.3d 839 (2000).

⁶³ *Simpson Inv.*, 141 Wn.2d at 138-139.

⁶⁴ Laws of 1970, Ex. Sess., ch. 101, § 2. CP 782-787. It was first enacted as RCW 82.04.430(10). In 1971, the Legislature amended and reenacted the first mortgage interest deduction as RCW 82.04.430(11). Laws of 1971, ch. 13, § 1. This deduction was later recodified as a separate section (RCW 82.04.4292) in 1980. See Laws of 1980, ch. 37, §§ 1, 12, 81. The recodification specifically stated that "[t]his separation shall not change the meaning of any of the exemptions or deductions involved." RCW 82.04.4292; *Simpson Inv.*, 141 Wn.2d at 150 n. 8.

⁶⁵ CP 777-780.

note for the Legislature dated February 2, 1970.⁶⁶ The fiscal note stated “[e]xempt from the tax [is] . . . “interest received on investments primarily secured by first mortgages or trust deeds (on nontransient residential properties)”⁶⁷ Conspicuously, the fiscal note did not list servicing fees or any other sources of income as exempt amounts.

One day later, the Director of the Department of Revenue sent a letter to the Chairman of the Senate Sub-Committee on Taxation and Revenue.⁶⁸ He provided the Chairman with a “position statement opposing the provision . . . [of] SHB 232 exempting *residential mortgage loan interest* from the business and occupation tax.”⁶⁹ Another Department of Revenue report on the same bill prepared one month later again discussed the impact of the “first mortgage interest” deduction and described the statutory provision as a deduction for “[a]mounts derived *as interest received on investments or loans.*”⁷⁰

The following year, 1971, the Legislature reenacted the first mortgage interest deduction to correct a double amendment of RCW 82.04.430 in 1970.⁷¹ In the accompanying explanatory note appearing on the face of the session law, the Legislature reiterated that the deduction was for interest.⁷² It described the scope of the deduction as “interest

⁶⁶ CP 822.

⁶⁷ *Id.*

⁶⁸ CP 792, 789-791.

⁶⁹ CP 791, 792.

⁷⁰ CP 825-826.

⁷¹ Laws of 1971, ch. 13, § 1 (explanatory note).

⁷² *Id.*

received on investments or loans secured by first mortgages or trust deeds on nontransient residential properties by certain financial businesses.”⁷³

Notably, none of the legislative history indicates that amounts other than interest were within the scope of the deduction. Rather, in each instance, the Legislature understood that the deduction was limited to interest.

3. For over thirty-five years the Legislature has acquiesced in the Department’s interpretation of the mortgage interest deduction.

In addition to the legislative history, the Legislature has acquiesced in the Department’s formal interpretative rule that the deduction in RCW 82.04.4292 is limited to interest. In determining the legislative intent of a statute, great weight is given to the contemporaneous construction of a statute by an agency charged with enforcing it.⁷⁴ The agency’s interpretation is especially significant when the Legislature silently acquiesces in the construction over a long period of time.⁷⁵ Such legislative acquiescence has occurred for over thirty-five years.

The mortgage interest deduction was first enacted in 1970.⁷⁶ Two months after the deduction was enacted, the Department promulgated WAC 458-20-146 (“Rule 146”). Rule 146 construed allowable deductions

⁷³ *Id.*

⁷⁴ *Lacey Nursing Ctr.*, 103 Wn. App. at 175.

⁷⁵ *Id.*

⁷⁶ Laws of 1970, Ex. Sess., ch. 101, § 2.

by banks from gross income. Rule 146 limited the mortgage interest deduction to interest.⁷⁷

The deductions generally applicable to financial business include the following:

...

2. Interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties.⁷⁸

One year later, the Legislature reenacted the first mortgage interest deduction, making no effort to give the deduction a meaning contrary to that in Rule 146.⁷⁹ In fact, the Legislature reiterated that the deduction was for interest.⁸⁰

The following year, in legislation allowing cities and towns to impose local B&O taxes on banks, the Legislature incorporated the mortgage interest deduction along with other banking deductions and made no changes that altered or modified the Department's interpretation.⁸¹

Within seven months of the Legislature allowing the B&O taxation of banks by cities, the Department promulgated rules defining allowable banking deductions.⁸² Like Rule 146, WAC 458-28-030 limited banks to a deduction solely for interest. These rules remain today as written in 1970 and 1972.

⁷⁷ CP 829.

⁷⁸ *Id.*

⁷⁹ Laws of 1971, ch. 13, § 1 (explanatory note).

⁸⁰ *Id.*

⁸¹ Laws of 1972, ch. 134, § 2; RCW 82.14A.010.

⁸² WAC 458-28-030.

Over the statute's thirty-five year history, the Legislature has not changed the mortgage interest deduction statute to expand its scope beyond the interpretation given to it by the Department in WAC 458-20-146 and WAC 458-28-030. The Legislature's acquiescence in the Department's construction of the first mortgage interest deduction is further confirmation that the deduction was intended to apply only to interest received on secured investments or loans.

This history and legislative acquiescence establishes a legislative intent to limit the first mortgage interest deduction to interest. The legislative committees that received the fiscal notes, letters, and reports understood that the deduction was limited to interest. It was the contemporaneous understanding of the Legislature when it amended the statute as well as the Department that promulgated rules interpreting the scope of the deduction. It is the construction that this Court has adopted and should continue to follow.

4. The Department's interpretation of the first mortgage interest deduction does not undermine the Legislature's purpose.

HomeStreet Bank contends, on the other hand, that the Department's interpretation of the first mortgage interest deduction undermines its legislative purposes. HomeStreet argues that a tax on servicing fees "would create a perverse incentive for home mortgage lenders to make fewer mortgage loans."

The economic burden of a tax on servicing fees would not create a disincentive to lenders. Servicing fees are simply too small in context of the amounts loaned, the interest collected, and the benefits received from secondary market lending to create any actual disincentive. No rational lender would forgo the benefits provided by secondary market sales. Secondary market lending augments a lender's profitability through increased gain on sales of loans, origination fees, and other service fees as well as an increased customer base. These benefits far outweigh the economic burden of a small tax (currently 1.5%) on servicing fees. It makes no sense that a tax on servicing fees would create any deterrent to an originating lender's participation in the secondary market.

Contrary to HomeStreet Bank's contention, the Department's interpretation of the first mortgage interest deduction does not create any disincentive to the lending of funds.

5. HomeStreet's interpretation of the first mortgage interest deduction is contrary to the rules of construction given to tax deduction statutes.

Finally, HomeStreet's interpretation of the first mortgage interest deduction conflicts with statutory rules of construction. In case of doubt or ambiguity, a tax deduction is construed against the taxpayer and in strictly, though fairly in keeping with its ordinary meaning.⁸³ HomeStreet Bank's interpretation of the first mortgage interest deduction rests on the

⁸³ *Simpson Inv.*, 141 Wn.2d at 149.

Legislature's use of the ambiguous phrase "amounts derived from interest." This ambiguity must be construed against HomeStreet. This Court in *Security Pacific*, the administrative agencies charged with interpreting the deduction, and the Legislature all have construed the first mortgage interest deduction as only a deduction for interest and not as a deduction for fees performed for services.

Taxation is the rule and deduction the exception.⁸⁴ Because deductions from the B&O tax do nothing more than carve out a narrow niche that the tax cannot reach,⁸⁵ this Court should read the interest deduction statute narrowly rather than creating the broader tax deduction that HomeStreet requests.

HomeStreet's interpretation broadens the statute's scope. Under HomeStreet's theory, the deduction stretches to any financial institution somehow tracing the source of a fee to interest received on a first mortgage. The tax deduction as posited by HomeStreet is not limited only to servicing fees. Other fees charged by financial institutions can be paid from the interest portion of a mortgage loan.⁸⁶ Contingency fees were charged in *TMS Mortgage, Inc.* and deducted from the interest portion of borrower payments.⁸⁷ These too are arguably paid from "amounts derived from interest."

⁸⁴ *Budget Rent-A-Car v. Dep't of Revenue*, 81 Wn.2d 171, 175, 500 P.2d 764 (1972).

⁸⁵ *Id.*

⁸⁶ See *TMS Mortgage, Inc. v. Dep't of Revenue*, BTA No. 54718 (2001)(contingency fee and insurance reimbursements).

⁸⁷ *Id.*

HomeStreet's interpretation would expand the tax deduction to any service fees paid from interest. This was not the intent of the Legislature when it created a deduction for interest. Thus, this Court must reject HomeStreet's interpretation of the mortgage interest deduction.

B. HomeStreet Bank's Attempts To Characterize Its Servicing Fee Income As Interest Should Be Rejected.

HomeStreet attempts to characterize its servicing fee income as "interest" or "retained interest."⁸⁸ HomeStreet's servicing fee income is neither "interest" nor "retained interest."

1. HomeStreet does not retain any interest in the sold mortgage loans.

First, HomeStreet Bank's servicing fees are not "retained interest" because HomeStreet does not receive "interest." The common meaning of "interest" is compensation for the use or forbearance of money.⁸⁹ In other words, interest compensates a person for the loss of the use of money loaned to another.⁹⁰ Washington courts recognize a distinction between amounts charged for the use or forbearance of money and fees charged for services.

Every amount paid to a lender is not necessarily a charge for the use of the money. The courts of this state have recognized that payment for services is not payment for the use of money and that a 'finder's fee' may indeed be

⁸⁸ *E.g.* Brief of Appellants at 4 ("retained interest"), 10 ("HomeStreet retains a valuable portion of the loan asset."), 15 (revenue at issue is "embedded as a part of interest).

⁸⁹ *Clifford v. State*, 78 Wn.2d 4, 6, 469 P.2d 549 (1970).

⁹⁰ *Id.*

referable to services rendered rather than to compensation for the loan of money.”⁹¹

Second, fees charged for services are not “retained interest.” HomeStreet Bank’s servicing fees were generated solely because it performed services for the loan owners and not because it was lending money to borrowers.⁹² HomeStreet Bank ceased being compensated for lending money when it sold the mortgage loans to new owners.⁹³

HomeStreet Bank’s fees are contractual servicing fees. The rights of a party to service mortgage loans emanate from the contracts that govern them.⁹⁴ “[T]he servicer does not have an interest in the land or in the mortgage itself.”⁹⁵ Rather, the servicer has a contract right that grants it a potential stream of income.⁹⁶ Fannie Mae contracts specify that HomeStreet holds a contract right and has no legal interest in the loans:

Each lender’s Mortgage Selling and Servicing Contract provides that servicing is a *contractual relationship*

⁹¹ *Lincoln v. Transamerica Inv. Corp.*, 89 Wn.2d 571, 576, 573 P.2d 1316 (1978); accord *Housing Finance Comm’n v. O’Brien*, 100 Wn.2d 491, 496-97, 671 P.2d 247 (1983)(servicing fees viewed as compensation for services); *Security Pacific*, 109 Wash. App. at 798 (in dicta, servicing fees are not interest); AGO 2005 No. 10 at 2-4 (“interest” for purposes of RCW 82.04.4292 “does not include amounts paid to a party for the performance of services in connection with a loan.”).

⁹² *Peoples Mortg. Co. v. Federal Nat’l Mortg. Ass’n*, 856 F. Supp. 910, 917 (E.D. Pa. 1994)(servicer receives annual fee as compensation for performing servicing functions).

⁹³ See e.g. CP 422, 496.

⁹⁴ Karen P. Gelernt, *Secondary Market Residential Mortgage Transactions*, ¶ 9.02[2] at 9-2; *American Bankers Mortg. Corp. v. Federal Home Loan Mortg. Corp.*, 75 F.3d 1401, 1411 (9th Cir. 1996)(seller/servicer relationship governed by contract); *Peoples Mortg. Co.*, 856 F. Supp. at 918 (contract and Guides to Lender set forth the terms and conditions of sales and servicing of mortgages).

⁹⁵ Karen P. Gelernt, *Secondary Market Residential Mortgage Transactions*, ¶ 9.02[3] at 9-4; *Matter of Maple Mortg., Inc.*, 81 F.3d 592, 595 (5th Cir. 1996) (debtor has no legal or equitable interest in servicing rights).

⁹⁶ Karen P. Gelernt, *Secondary Market Residential Mortgage Transactions*, ¶ 9.02[1] at 9-1; see *Amer. Bankers*, 75 F.3d at 1411; *Peoples Mortg.*, 856 F. Supp. at 918.

between the lender and Fannie Mae (as owner of all right, title, and interest in mortgages the lender has delivered to us) that is established for the particular mortgages when we acquire them⁹⁷

The servicing contract is a “set of instructions from a lender-principal to a servicer-agent; it is not a contract between borrower and lender.”⁹⁸

Third, the servicer acts merely in a fiduciary capacity for the loan owners.⁹⁹

Since these funds and assets are owned by Fannie Mae and other parties (such as the borrower, a participating lender, or a mortgage-backed security holder), the servicer in its handling of these funds is acting on behalf of, and as a fiduciary for, Fannie Mae and other parties, as their respective interests may appear—and not as a debtor of Fannie Mae.

A fiduciary relationship with the loan owners does not create a “retained interest” in borrower payments when the borrowers’ obligations as well as all security interests in the loans belong to Fannie Mae and other beneficial loan owners. Because HomeStreet Bank did not receive “interest” or a “legal interest” in the loans, HomeStreet did not receive any “retained interest” in the secured loans.

2. HomeStreet Bank’s servicing rights do not create a retained interest in the mortgage loans.

HomeStreet Bank goes on to state that it retains an interest in the loans because its sells a portion of the loan asset and retains interest rate

⁹⁷ CP 496, 422, 425, 493, 497.

⁹⁸ *Huntington Mortgage Co.*, 703 N.E. 2d at 166; *Deerman*, 955 F. Supp. at 1404-1405 (borrowers are not parties or third-party beneficiaries to servicing contract).

⁹⁹ CP 514.

risk.¹⁰⁰ HomeStreet Bank is incorrect. The servicing right was stripped from the loans when HomeStreet Bank sold the mortgage loans to Fannie Mae. Because the servicing right is no longer part of the loans sold, HomeStreet Bank cannot retain any “interest” in the loans.

“[T]he economic value of a mortgage loan springs from two sources—the payment obligation represented by the mortgage note and the servicing.”¹⁰¹ If the lender who originates the loan retains the mortgage loan in its portfolio, “the servicing rights remain an undivided feature of the mortgage loan.”¹⁰² The owner of a mortgage loan, however, severs the servicing rights from the mortgage loan when a non-owner services the loans.¹⁰³ When severed from the mortgage loan, servicing becomes an independent “asset” or “right” with no interest retained in the land or mortgage itself.¹⁰⁴

Servicing rights are purchased, sold and financed separately from mortgage loans.¹⁰⁵ Servicing can be pledged as collateral and its receivables sold in whole or in part.¹⁰⁶ Servicing has become an industry unto itself involving primary servicers, subservicers, subprime servicers,

¹⁰⁰ Brief of Appellants at 19.

¹⁰¹ Karen P. Gelernt, *Secondary Market Residential Mortgage Transactions*, ¶ 9.02[1] at 9-1.

¹⁰² *Id.* The same is true if the servicing rights are sold with the loan.

¹⁰³ *Id.* at 9-1–9-2.

¹⁰⁴ *Id.* (“In the mortgage banking industry, servicing rights represent an important by-product of every mortgage loan closed”)

¹⁰⁵ *Id.*, ¶ 9.02[1] at 9-2; ¶ 10.01 at 10-1 (“Servicing has become an asset that can be purchased; sold, and financed separate from the mortgage loans for which services are performed.”); *accord* CP 347-348 (“There is an active market in which lenders sell servicing rights and obligations to other servicers.”).

¹⁰⁶ CP 497; Karen P. Gelernt, *Secondary Market Residential Mortgage Transactions*, ¶ 11.01 at 11-1.

subprime subservicers, and special servicers.¹⁰⁷ Because servicing exists separately once stripped from the loans, it does not represent any continuing legal interest in the underlying loans as HomeStreet contends.

Interest rate risk is also not evidence of a “retained interest.” The value of servicing rights and mortgage loans react in opposite directions to changing interest rates:¹⁰⁸

In rising interest rate environments, the value of existing mortgage loans declines, whereas the value of servicing rights for those same mortgage loans rises. Conversely, a lender owning a 30-year fixed-rate loan will see the value of the mortgage loan rise as interest rates fall because the rate on the mortgage loan will be higher relative to the general market. The owner of the servicing rights will see the marketplace discount the value of those rights, in anticipation of greater prepayment activity, which negatively affects the long-term income stream of servicing if interest rates drop.¹⁰⁹

Thus, the risks of interest rate changes to a servicer differ from the risks associated with owning the underlying loan. The differing risks provide no support for HomeStreet Bank’s contention that it “retains an interest” in the loans.

Finally, HomeStreet alleges that deposition testimony by the Department’s expert witness, Earl Baldwin¹¹⁰ supports its arguments of a “retained interest.” It alleges that Mr. Baldwin agreed that the fees

¹⁰⁷ <http://www.mortgageservicingnews.com/plus/data/> (links to top 10 conventional servicers, subprime servicers, subservicers, and subprime subservicers); http://www.c-loans.com/conduit_loans.html (discussing primary and special servicers). HomeStreet subservices a small number of mortgage loans. CP 327-328.

¹⁰⁸ Karen P. Gelernt, *Secondary Market Residential Mortgage Transactions*, ¶ 10.01 at 10-1.

¹⁰⁹ *Id.*

¹¹⁰ Brief of Appellants at 21-23.

HomeStreet received were “derivatives” and, thus, “derived from interest.”

Mr. Baldwin stated more than once in his deposition testimony that he had no knowledge of the tax issue in this case and had no opinion about the proper taxation of HomeStreet.¹¹¹ The fact that Fannie Mae allowed HomeStreet to take its servicing fees from borrower interest paid to loan owners is not disputed. Mr. Baldwin was not offering an opinion on whether servicing fees are “amounts derived from interest received on investments or loans primarily secured by first mortgages” within the meaning of RCW 82.04.4292.

Mr. Baldwin stated that servicing fees were “derivative of mortgages” only in the sense that the fee is deductible from the interest portion of the loan. He clarified that servicing fees are not derivative instruments as that term is used in the industry.¹¹² A servicing contract does not strip away any rights to borrower interest payments, it strips away a right to servicing fees.¹¹³ “An interest only strip is a structured security, like a mortgage-backed security, that is registered and sold in the fixed income capital markets.”¹¹⁴ Servicing fees are not an interest strip.¹¹⁵

HomeStreet Bank’s claim of a “retained interest” in the first mortgages is illusory. It has no legal interest in the mortgage loans that

¹¹¹ CP 50, 53-54, 748.

¹¹² CP 748-749.

¹¹³ CP 748.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

would qualify its servicing fee income for the first mortgage interest deduction.

C. The Department Did Not Inconsistently Interpret The First Mortgage Interest Deduction Statute.

HomeStreet Bank in closing implies that the Department has inconsistently interpreted the first mortgage interest deduction and that a current Department published determination entitles it to a tax deduction.¹¹⁶ It claims that the Department allowed HomeStreet Bank a deduction for retained interest in 1992, but now denies it a refund request.¹¹⁷ It further claims that it should qualify under the Department's current Determination No. 98-218, 18 WTD 46 (1999) because it retains rights in the loans.¹¹⁸ HomeStreet misconstrues the Department's prior 1992 unpublished determination. It is also not entitled to a mortgage interest deduction under the Department's 1999 published determination.

First, HomeStreet Bank fails to discuss that the factual assumptions of the 1992 determination differ from the record on review. In *the Matter of Continental, Inc., et.al.*, Det. No. 92-403 (1992)¹¹⁹ the Department believed that Continental assigned "some, but not all of its rights in the first mortgage notes and deeds of trust" when the loans were sold on the secondary market.¹²⁰ Because only a partial assignment occurred and

¹¹⁶ Brief of Appellants at 5-6, 19-23.

¹¹⁷ Brief of Appellants at 5-6.

¹¹⁸ Brief of Appellants at 19-23.

¹¹⁹ CP 147-157 (Det. No. 92-403 (1992)). HomeStreet, Inc is a successor to Continental, Inc., and HomeStreet Bank became the successor to Continental Saving Bank.

¹²⁰ CP 152.

Continental supposedly remained a beneficial owner of a portion of the underlying mortgage loans, the Department found that the income Continental received was in fact “interest.”¹²¹

The Continental determination is factually inconsistent with the summary judgment record on review. The Fannie Mae contracts unequivocally assign all HomeStreet Bank’s legal interests in the secured loans to Fannie Mae.¹²² HomeStreet does not execute a partial assignment, but a full assignment of all its rights in the mortgage loans.¹²³ These facts differentiate the assumed facts in the 1992 *Continental* determination from those before the Court here.

Even if the background facts in the 1992 *Continental* determination were similar, the Department clearly misconstrued the nature and terms of Continental’s contracts with Fannie Mae and Ginnie Mae. It appears 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.

Although the Department may have misconstrued the facts in that determination, the Department’s interpretation of the scope of the first mortgage interest deduction statute has remained consistent.¹²⁴ A taxpayer

¹²¹ CP 155. The other cases provided by HomeStreet Bank were similarly decided. CP 67 (This sale is accomplished through the assignment of some, but not all, of the taxpayer’s rights in the note and deed of trust representing the loan.”); CP 116, 124 (same); CP 140-141 (same).

¹²² CP 454 (assignment), 425 (absolute sale of all rights), 426 (same), 428 (same).

¹²³ CP 454, 425, 426, 428.

¹²⁴ WAC 458-20-146; CP 103-106; *Security Pacific*, 109 Wn. App. at 800.

must have a legal or beneficial ownership interest in the loan to receive the first mortgage interest deduction.¹²⁵ Only a legal or beneficial ownership interest in the underlying secured loan entitles the taxpayer to a portion of the borrower's interest payment. Only interest received by an owner or beneficial owner is entitled to a first mortgage interest deduction. The Department, consequently, has not inconsistently construed the first mortgage interest deduction, as HomeStreet Bank contends.

Second, the Department's Determination No. 98-218, 18 WTD 46 (1999) does not entitle HomeStreet to a first mortgage interest deduction under RCW 82.04.4292. HomeStreet Bank again fails to discuss either the facts or holding in Determination No. 98-218. Determination No. 98-218 dealt with fees charged by pure mortgage brokers and lending brokers.¹²⁶ The Department held that fees received for specific services are not entitled to the first mortgage interest deduction.¹²⁷ This analysis applies equally here. HomeStreet Bank received contractual servicing fees for servicing mortgage loans on behalf of the loans' owners. Its receipt of fees for specific services does not qualify it for the first mortgage interest deduction -- just as the mortgage broker fees did not qualify in Det. No. 98-218.

Deduction statutes are to be narrowly construed. HomeStreet posits a construction of the first mortgage interest deduction, RCW

¹²⁵ *Security Pacific*, 109 Wn. App. at 800; CP 103-106.

¹²⁶ CP 96-98.

¹²⁷ CP 103-106.

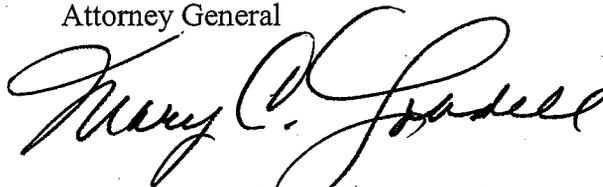
82.04.4292, that is adverse to this Court's interpretation as well as legislative history. It is a construction that this Court must reject. HomeStreet does not receive any retained interest in the first mortgage loans that it sells to Fannie Mae. Lacking a beneficial interest in the loans, HomeStreet is not entitled to a first mortgage interest deduction under RCW 82.04.4292.

V. CONCLUSION

For these reasons, this Court should affirm the summary judgment order by the superior court.

RESPECTFULLY SUBMITTED this 6th day of September, 2006.

ROB MCKENNA
Attorney General

A handwritten signature in cursive script, appearing to read "Mary C. Lobdell".

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Senior Counsel

NO. 34738-5-II

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

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

Appellants,

v.

STATE OF WASHINGTON,
DEPARTMENT OF REVENUE,

Respondent.

DECLARATION OF
SERVICE

I, Carrie A. Parker, state and declare as follows:

I am a citizen of the United States of America and over 18 years of age and not a party to this action. On September 6, 2006, I provided a true and correct copy of BRIEF OF RESPONDENT and this DECLARATION OF SERVICE to be served via U.S. mail (through Consolidated Mail Services), with proper postage affixed to:

Robert L. Mahon
Scott Edwards
Gregg Barton
Perkins Coie LLP
1201 Third Avenue, Suite 4800
Seattle, WA 98101

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

Executed this 6th day of September, 2006, at Olympia, Washington.

A handwritten signature in cursive script that reads "Carrie A. Parker". The signature is written in black ink and is positioned above a horizontal line.

Carrie A. Parker
Administrative Assistant