

State Supreme Court Rules on Scope of B&O Tax Mortgage Interest Deduction

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In 1980, when extending the business and occupation (B&O) tax to financial institutions, the legislature provided a deduction for “amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds” on residential properties. The purpose of the exemption was to stimulate the state’s housing market by making residential home loans more affordable.

The scope of the deduction has been a matter of some controversy over the years and has led to two state Supreme Court cases and several statutory amendments. In *HomeStreet, Inc. v. Department of Revenue*, 166 Wn.2d 444 (2009) the court held that the deduction applies to amounts retained by a lender that securitizes the loan on a servicing retained basis because the amounts received from the securitized loans are “derived from” interest payments on the loans.

The department’s efforts to amend the law in response to the court’s decision resulted in the legislature effectively codifying the result in *HomeStreet* in 2010 but limiting the availability of the deduction effective 2012 to banks operating in fewer than ten states. It also added a requirement that the entity claiming the deduction must have originated the loan, acquired the loan from the originator or be under common control with the originator, and adding some express exclusions from the deduction.

This fall, the court held that the pre-amendment version of the deduction does not apply to interest payments banks receive on investment in certain mortgage backed securities, including real estate mortgage investment conduits (REMICs) and collateralized mortgage obligations (CMOs). *Cashmere Valley Bank v. Department of Revenue*, 334 P.3d 1100 (Wash. Sept. 25, 2014).


The court noted that its *HomeStreet* decision identified five statutory requirements for the deduction: (1) the taxpayer must be a “banking, loan, security, or other financial business;” (2) the amount deducted must be “derived from interest” received; (3) the amount deducted was received because of loan or investment; (4) “primarily secured” by a first mortgage or deed of trust; and (5) on “nontransient residential real property.” According to the court, there was no dispute that four of the five requirements were satisfied; the only issue was whether REMICs are “primarily secured” by the underlying mortgages.

On this issue, the court held that to satisfy the “primarily secured” by a mortgage or deed of trust requirement, the bank claiming the deduction must have “some recourse” against the collateral. The court found that a REMIC investor has “no direct or indirect legal recourse” against the underlying mortgages.

In reaching this conclusion the court appears to have accepted the testimony of an expert witness offered by the department, who “testified that REMIC investments are not secured transactions because issuers do not pledge any property as security for the investments.” The court also deferred to an earlier department ruling in an administrative appeal, in which the department

distinguished between “pass-through” mortgage investments (in which the investor has a beneficial interest in the underlying mortgages) and the type of mortgage backed securities at issue in the case, with respect to which the court concluded that the investor’s rights to payment were simply contractual with the investor lacking authority to force a foreclosure and not necessarily entitled to recoveries from a foreclosure. Based on this distinction the court held “if the terms of the trust do not give beneficiaries an investment secured by trust assets, the trustee’s fiduciary obligations do not transform the investment into a secured investment.” Because its investments failed that test, the court held that the deduction was not available.

Potential Future Elimination of the Deduction.

When rejecting a policy argument made by the bank, the court noted that in 2011 a legislative task force that periodically reviews “tax preferences” expressed doubt whether the deduction advances its stated purpose of increasing access to home mortgage loans. Thus, as part of the 2012 amendments, the legislature directed the committee to further review the deduction and recommend by June 2015 whether the deduction “should be continued without modification, modified, or terminated immediately.” Given the committee’s previously expressed doubt, the deduction may be nearing its end unless the banking community can convince the legislature that the deduction advances its stated goal. 



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