Cite as Det. No. 20-0061, 41 WTD 337 (2022)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Refund of	)	D E T E R M I N A T I O N
	)	
	)	No. 20-0061
	)	
. . .	)	Registration No. . . .
	)	

[1] WAC 458-20-254; RCW 82.32.070; RCW 82.04.4292. RECORDS – MORTGAGE-BACKED SECURITY DEDUCTION. Taxpayer has not provided copies of the relevant participation certificates or any other documentation to establish that Taxpayer has a legal interest in the underlying mortgages and deeds of trust or that it is a beneficiary of those instruments. Taxpayer has not shown that it has a right to sell the mortgage loans or any other asset of the trust to satisfy trust obligations to investors, or that it has the right to compel the trustee to foreclose on individual properties. Further, Taxpayer has not shown that if a trustee can and does foreclose, proceeds from the sale must go to the investors.

[2] RCW 82.32.070 and WAC 458-20-254(3)(b) require that Taxpayer make this supporting documentation available to the Department. Taxpayer has failed to do so. Thus, by failing to submit the relevant documentation, Taxpayer has failed to meet its burden of proving that it is entitled to the deduction under RCW 82.04.4292.

[3] WAC 458-20-254; WAC 458-20-146; RCW 82.32.070; RCW 82.04.4286. RECORDS – MORTGAGE INTEREST DEDUCTION – OBLIGATION OF FEDERAL, STATE, OR LOCAL GOVERNMENT. Taxpayer has failed to provide any documentation showing that the interest amounts received from investments in Ginnie Mae are the direct obligations of the Federal Government. While Taxpayer alleges that the prospectuses for the Ginnie Mae securities state that "Ginnie Mae guaranties will constitute general obligations of the United States, for which the full faith and credit of the United States is pledged," this language by itself is insufficient to establish that the securities constitute a direct obligation of the United States Government. *Rockford*, 482 U.S. at 188–89. Rather, this language operates only to establish the government is the guarantor of the securities. *Id*. Taxpayer has provided no documentation to show that Ginnie Mae is the primary issuer of any of the securities at dispute here. Taxpayer is not entitled to deduct interest income received from investments in Ginnie Mae under WAC 458-20-146(3) and RCW 82.04.4286.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

McBryde, T.R.O. – A financial institution argues that it is entitled to deduct interest income earned on certain investments from its gross income for the purposes of calculating its business and occupation tax liability. We deny the petition.[1]

ISSUES

1. Whether, under RCW 82.32.070 and WAC 458-20-254(3)(b) ("Rule 254(3)(b)"), a financial institution has provided sufficient records to establish that it has a security interest in the underlying mortgage for its mortgage-backed securities investments for the purposes of qualifying for the deduction of interest income under RCW 82.04.4292(1).

2. Whether, under RCW 82.04.4292(1), a financial institution may deduct interest income earned from investments in mortgage-backed securities where the mortgaged property is an assisted living facility.

3. Whether, under RCW 82.32.070 and Rule 254(3)(b), a financial institution has provided sufficient records to establish that the interest income earned from investments guaranteed by the Government National Mortgage Association qualifies for a deduction under RCW 82.04.4286, 31 U.S.C. § 3142(a), and WAC 458-20-146(3) ("Rule 146(3)").

FINDINGS OF FACT

. . . ("Taxpayer") is a financial institution headquartered in . . . Taxpayer operates various branches in Washington . . . [and other states].

In March 2016, Taxpayer submitted a request for refund in the amount of $. . . with regard to certain asserted deductions of investment interest income received during the period of January 1, 2011, through December 31, 2016.

The Department of Revenue's Audit Division ("Audit") reviewed Taxpayer's request, which resulted in the issuance of the following audit reports: A. . . for the 2011 tax year, A . . . for the 2012 – 2014 tax years, A… for the 2015 tax year, and A. . . for the 2016 tax year. On December 20, 2018, Audit granted a total refund in the amount of $. . . , and denied the remainder of Taxpayer's refund request.[ ]

On February 19, 2019, Taxpayer submitted a Review Petition, protesting $. . . of the denied refund. The protested portion relates to the deduction of interest income from various investments as detailed below.

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

Mortgage-Backed Securities and Home-Equity Conversion Mortgage-Backed Securities Investments (Fannie Mae, Freddie Mac, Ginnie Mae)

Taxpayer earned interest income on investments in mortgage-backed securities ("MBS" investments) and home equity conversion mortgage-backed securities ("HMBS" investments) issued by the Federal Home Loan Mortgage Corporation ("Freddie Mac"), the Federal National Mortgage Association ("Fannie Mae"), and the Government National Mortgage Association ("Ginnie Mae"). Taxpayer asserts that this interest income is deductible under RCW 82.04.4292.

Fannie Mae and Freddie Mac are government-sponsored enterprises. They are private companies established and chartered by the Federal Government for public policy purposes, including to provide assistance to the secondary market for residential mortgages. Ginnie Mae is a wholly owned governmental corporation housed within the Department of Housing and Urban Development ("HUD").

These entities purchase mortgages from the secondary market, group the mortgages together as a pool, and sell them as MBS investments to investors on the open market. Taxpayer describes its MBS investments operating as a right to receive income streams from a pool of mortgages. However, Taxpayer has failed to provide copies of its participation certificates or any other documentation to establish that Taxpayer has legal recourse to enforce the underlying mortgages or deeds of trust. . . . On these bases, Audit determined that Taxpayer did not meet the requirements of RCW 82.04.4292 and denied the claimed interest deduction as to the MBS investments from Fannie Mae, Freddie Mac, and Ginnie Mae.

Taxpayer also maintains HMBS investments provided by Ginnie Mae, which are MBS investments in which the collateralized property is secured by a reverse mortgage. Taxpayer again failed to provide Audit with any documents establishing that Taxpayer has legal recourse to enforce the underlying first mortgages or deeds of trust. On this basis, Audit determined that Taxpayer did not meet the requirements of RCW 82.04.4292 and denied the claimed interest deduction as to the HMBS investments from Ginnie Mae.

Deduction of Non-Passthrough Securities Obliged by Federal Government (Ginnie Mae)

Taxpayer additionally earned interest income on investments from numerous real estate mortgage investment conduits ("REMIC" investments) and collateralized mortgage obligations ("CMO" investments) backed by Ginnie Mae. Taxpayer asserted that this interest income was properly deductible under Rule 146(3) as interest income received from a direct obligation of the Federal Government.

For all Ginnie Mae securities, Taxpayer asserts that the prospectus states as follows:

GINNIE MAE GUARANTY

> [Ginnie Mae], a wholly owned corporate instrumentality of the United States of America within HUD, guarantees the timely payment of principal and interest on the Securities. The General Counsel of HUD has provided an opinion to the effect that Ginnie Mae has the authority to guarantee multiclass securities and that Ginnie

> Mae guaranties will constitute general obligations of the United States, for which the full faith and credit of the United States is pledged.

Taxpayer argues that this Ginnie Mae Guaranty demonstrates that the Federal Government is not a mere guarantor or insurer on all Ginnie Mae-issued securities, but is instead a direct obligor. However, Taxpayer has failed to provide any supporting documentation for these REMIC and CMO investments. Based on the foregoing, Audit found that Taxpayer failed to show that Ginnie Mae is the issuer and primary obligor of the securities. On this basis, Audit determined that the interest income received on the Ginnie Mae guaranteed securities did not qualify the deduction under Rule 146(3).

ANALYSIS

Washington imposes a business and occupation ("B&O") tax "for the act or privilege of engaging in business" in the State of Washington. RCW 82.04.220. The measure of the B&O tax is the application of rates against "value of products, gross proceeds of sales, or gross income of the business, as the case may be." RCW 82.04.220. The B&O tax measure and rate are determined by the type or nature of the business activity in which a person is engaged. RCW 82.04.290.

Here, Taxpayer engages in commercial banking activities and its gross income is subject to the service and other activities B&O tax, unless an exemption applies. The measure of the B&O tax is equal to the gross income, or the gross sales of the business multiplied by the specified rate. RCW 82.04.290. Gross income of the business is defined in RCW 82.04.080 as:

> "Gross income of the business" means the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

Thus, banks and certain other financial businesses must pay B&O tax on most income from investments. RCW 82.04.4281(2)(b); Rule 146. The B&O tax is a gross receipts tax, not a net income tax. "The legislative purpose behind the B&O tax scheme is to tax virtually all business activity in the state. . . ." *Impecoven v. Dep't of Revenue,* 120 Wn.2d 357, 363, 841 P.2d 752 (1992).

1. Deduction for Interest Received on Investments.

RCW 82.04.4292 provides a statutory deduction from the B&O 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."

Consequentially, RCW 82.04.4292 requires that each of the following elements be met to qualify for the deduction:

(1) the taxpayer is engaged in a banking, loan, security, or other financial business;
(2) the amount deducted is from interest;
(3) the interest is from an investment or loan;
(4) the taxpayer's loan or investment is primarily secured by first mortgage or trust deed; *and*
(5) the first mortgage or trust deed creates a security interest in nontransient residential real property.

There is no dispute that Taxpayer is a bank, that the amount deducted is interest, and that the interest was received from an investment. At issue here are: (1) whether Taxpayer's MBS and HMBS investments are "primarily secured by" first mortgages or deeds of trust; and (2) whether the first mortgages create a security interest in "nontransient residential real property."

Generally, taxation is the rule and deductions, or exemptions are exceptions to the rule. *Budget Rent-A-Car, Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 174, 500 P.2d 764 (1972). Thus, we construe deductions to taxation narrowly, but fairly, and the party claiming the deduction has the burden of showing that it qualifies for the deduction. *Id*. at 174-75.

Furthermore, RCW 82.32.070 requires every person liable for the payment of excise taxes to keep and preserve for a period of five years, suitable records as may be necessary to determine the person's tax liability. The law also requires the person to make those records open for examination at any time by the Department. *Id.*

Rule 254(3)(b) states in pertinent part:

> It is the duty of each taxpayer to prepare and preserve all records in a systematic manner conforming to accepted accounting methods and procedures. Such records are to be kept and preserved. All of the taxpayer's records must be presented upon request by the department or its authorized representatives that will demonstrate:
> . . .
> (ii) The amounts of all deductions, exemptions, or credits claimed through supporting records or documentation required by statute or administrative rule, or other supporting records or documentation necessary to substantiate the deduction, exemption, or credit.

Investment "Primarily Secured" by First Mortgage or Trust Deed

In *Cashmere Valley Bank v. Dept. of Revenue*, 181 Wn.2d 622, 334 P.3d 1100 (2014), the Washington Supreme Court held that a bank's REMIC and CMO investments were not secured by first mortgages or trust deeds. The CMO and REMIC investments only provided the bank with a right to receive defined income streams (i.e., [sourced from] mortgage payments) from a pool of mortgages, trust deeds, and mortgage-backed securities, held in trust for investors. *Id*. at 625. In the event that the [trustee of the CMO or REMIC investment] failed to [pay Cashmere according

to the terms of the investment, Cashmere had no right of recourse against the mortgages underlying the investment, and its] only recourse would be to sue the trustee for performance of the obligation or attempt to replace the trustee. *Id*. at 634-35.

The Court explained that for an investment to be "primarily secured" for the purposes of qualifying for the statutory deduction set forth in RCW 82.04.4292, the investment must be backed by an encumbrance on real property, or the investor must have a right of legal recourse to the underlying trust assets in the event of a default. *Id*. at 625, 639–40. An investor's right of legal recourse may be either direct or indirect. *Id*. at 639–40.

In contrast to REMIC and CMO investments, the *Cashmere Valley Bank* Court notes that an investment in [what are referred to as] pass-through securities are "primarily secured by" first mortgages where the investment represents a beneficial ownership of a fractional undivided interest in a pool of first lien residential mortgage loans. 181 Wn.2d at 637 (citing Det. No. 90-288, 10 WTD 314 (1990)). The issuer holds the mortgages in trust for the investors and has the ability to foreclose on the property in the event of default. *Id.* at 636. The proceeds from foreclosure must then flow to the investors who have a beneficial ownership interest in the underlying mortgage. *Id*.

However, as *Cashmere Valley Bank* notes, the mere fact that the trustee may be able to foreclose on behalf of trust beneficiaries does not mean an investment is "primarily secured" by a first mortgage or trust deed. *Id.* at 641. The investor must have a legally enforceable right to the underlying trust assets. *Id.* at 635 n.12 (instructing that "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"). The determinative factor between the deductibility of an investment in a pass-through security and the non-deductibility of REMIC or CMO investment, then, is whether the investor can show that it has a legally enforceable interest in the underlying mortgage or trust deed, or the investor is a beneficiary of these instruments. *Id*. at 634.

Here, Taxpayer has failed to demonstrate that the interest income from its MBS and HMBS investments is deductible under RCW 82.04.4292. Taxpayer argues that its MBS and HMBS investments operate as deductible pass-through securities. However, Taxpayer has not provided copies of the relevant participation certificates or any other documentation to establish that Taxpayer has a legal interest in the underlying mortgages and deeds of trust or that it is a beneficiary of those instruments. Taxpayer has not shown that it has a right to sell the mortgage loans or any other asset of the trust to satisfy [trust] obligations [to investors], or that it has the right to compel the trustee to foreclose on individual properties. Further, Taxpayer has not shown that if a trustee can and does foreclose, proceeds from the sale must go to the investors.

RCW 82.32.070 and Rule 254(3)(b) require that Taxpayer make this supporting documentation available to the Department. Taxpayer has failed to do so. Thus, by failing to submit the relevant documentation establishing that Taxpayer has a legally enforceable interest in the underlying trust assets of its MBS and HMBS investments, Taxpayer has failed to meet its burden of proving that it is entitled to the deduction under RCW 82.04.4292. *Budget Rent-A-Car*, 81 Wn. 2d at 174-75. . . .

2. Deduction for Interest Earned on Obligations of the Federal Government

Banks, savings and loan associations, and other financial institutions [may deduct] interest income received on direct obligations of the Federal Government. RCW 82.04.4286; Rule 146(3); Det. No. 89-476, 8 WTD 271 (1989). RCW 82.04.4286 recognizes a deduction from the measure of B&O tax for "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." This is consistent with 31 U.S.C. § 3124(a) (formerly codified as 31 U.S.C. § 742, with minor variations in its language), which bars states from taxing "[s]tocks and obligations of the United States Government," subject to certain exceptions.

Rule 146 explains how RCW 82.04.4286 applies to income earned by banks and states: "A deduction may also be taken for interest received on *direct obligations of the federal government*, but not for interest attributable to loans or other financial obligations on which the federal government is merely a guarantor or insurer." Rule 146(3) (emphasis added).

"It is [only] the obligation of the payment itself which must be direct, not the method of payment . . . even if the method of payment is through another bank." Det. No. 89-476, 8 WTD 271 (1989). Examples of direct obligations of the Federal Government include Treasury bills, Treasury notes, Treasury bonds, and U.S. Savings Bonds. *See, e.g., id.* (holding that a deduction was proper for interest income from a Federal Reserve Bank attributable to its interests in Federal securities).

. . . Ginnie Mae is a wholly owned government corporation within HUD and is considered a Federal Government agency.[ ] Generally, Ginnie Mae does not directly issue MBS; it auctions Ginnie Mae mortgages to private lenders, which may pool them into MBS investments for resale in the secondary market. However, it does appear that Ginnie Mae may be authorized to directly issue securities in certain circumstances.[2]

In *Rockford Life Ins. Co. v. Illinois Dept. of Revenue*, 482 U.S. 182, 107 S. Ct. 2312, 96 L. Ed. 2d 152 (1987), the United States Supreme Court addressed the issue of whether income from Ginnie Mae, specifically securities issued by private financial institutions possessing a pool of Federally-guaranteed mortgages, was subject to state taxation. The instruments involved were standard securities bearing the title "Mortgage Backed Certificate Guaranteed by [Ginnie Mae]." *Id.* at 185. Each instrument contained a provision in which Ginnie Mae guaranteed the "full faith and credit of the United States" to secure the timely payment of the interest and principal set forth in the instrument. *Id.* at 186.

The Court held that because the government was only the guarantor of the securities, not the primary obligor, the securities were not "obligations of the United States Government" within the

[2] *See Montgomery Ward Life Ins. Co. v. State, Dept. of Local Gov't Affairs*, 89 Ill.App.3d 292, 299, 411 N.E.2d 973, 978 (1980), which noted that "Ginnie Mae [certificates] . . . issued under 12 U.S.C. § 1721(g) (1976) differed from Mortgage Participation Certificates issued under 12 U.S.C. § 1717(c) (1976) and the Fannie Maes issued under 12 U.S.C. § 1719(d) (1976). Under the latter two sections [Fannie Mae and Ginnie Mae] issue the certificates and are directly liable for payment. By contrast, the instant guarantee of payment [of the Ginnie Mae certificates issued under § 1721(g)] is truly an indirect and contingent obligation of the United States and does not exempt the Ginnie Maes from state taxation."

meaning of 31 U.S.C. § 742 (1976) and, thus, not exempt from the taxing power of the states.[3] *Id*. at 188–89. In its analysis, the Court cited these four characteristics of obligations of the United States that are exempt from state taxation: "(1) written documents, (2) the bearing of interest, (3) a binding promise by the United States to pay specified sums at specified dates and (4) specific Congressional authorization, which also pledged the full faith and credit of the United States in support of the promise to pay." *Id*. at 189–90. In *Rockford*, the Court found that the instruments failed to meet the third factor. *Id*. at 190.

Again, the deductions are narrowly construed, and taxpayers claiming deductions have the burden of showing that they qualify. *Budget Rent-A-Car, Inc.*, 81 Wn.2d at 174-75. Taxpayers must maintain books and records to support claimed deductions. RCW 82.32.070; Rule 254(3)(b)(ii). If taxpayers cannot provide supporting documents, they are not entitled to a deduction.

Here, Taxpayer has failed to provide any documentation showing that the interest amounts received from investments in Ginnie Mae are the direct obligations of the Federal Government. While Taxpayer alleges that the prospectuses for the Ginnie Mae securities state that "Ginnie Mae guaranties will constitute general obligations of the United States, for which the full faith and credit of the United States is pledged," this language by itself is insufficient to establish that the securities constitute a direct obligation of the United States Government. *Rockford*, 482 U.S. at 188–89. Rather, this language operates only to establish the government is the guarantor of the securities. *Id*. Taxpayer has provided no documentation to show that Ginnie Mae is the primary issuer of any of the securities at dispute here.

Based on the foregoing, we conclude that Taxpayer is not entitled to deduct interest income received from investments in Ginnie Mae under Rule 146(3) and RCW 82.04.4286.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 19th day of February 2020.

[3] 31 U.S.C. § 742 (1976) provided as follows: "Except as otherwise provided by law, all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority . . . ."