

Cite as 10 WTD 314 (1990).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition)	<u>D E T E R M I N A T I O N</u>
For Refund of)	
)	No. 90-288
)	
. . .)	
)	Registration No. . . .
)	. . ./ Audit No. . . .
)	

[1] RULE 146: RCW 82.04.4292 -- B&O TAX -- DEDUCTION -- INTEREST ON INVESTMENT OR LOAN SECURED BY FIRST MORTGAGE -- COLLATERALIZED MORTGAGE OBLIGATION. Interest received on bond secured by mortgage-backed security is not deductible as interest received from a investment or loan primarily secured by first mortgage or trust deed on nontransient residential properties. The primary security for the bond is a readily tradeable investment instrument rather than a qualifying mortgage.

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.

TAXPAYER REPRESENTED BY: . . .

DATE OF TELECONFERENCE: . . .

NATURE OF ACTION:

The taxpayer seeks a refund of business and occupation tax assessed on interest earned from investment in bonds secured by mortgage-backed securities.

FACTS AND ISSUES:

Heller, A.L.J. -- The taxpayer is a savings and loan association doing business in the State of Washington. The Department of Revenue ("Department") conducted an audit of the taxpayer's books and records for the period . . . , 1985

through . . . , 1989. As a result of this audit, a Notice of Assessment dated . . . , 1989, was issued in the amount of \$ This assessment includes business and occupation tax in the amount of \$. . . which the auditor found to be due on certain interest earned by the taxpayer from its investment activities.

As a part of its investment portfolio, the taxpayer holds a certain type of bonds generally referred to in the banking and investment security industries as "collateralized mortgage obligations" or "CMOs" (hereinafter referred to as CMOs or bonds). A CMO is a debt obligation secured by publicly traded mortgage-backed securities.

In every CMO transaction there are two separate investment instruments involved. The CMO is the primary obligation to the bondholder and the mortgage-backed security is the collateral for the repayment of the CMO. Mortgage-backed securities are certificates issued by a financial institution which originates or has acquired a pool of qualifying mortgages. Qualifying mortgages are those insured by a quasi-governmental organization chartered by the U.S. government such as the Government National Mortgage Association ("GNMA"). The issuing financial institution enters into a guarantee agreement with the government insurer and then sells the mortgage pool to investors in the form of mortgage-backed securities. In all cases the underlying loans are secured by first mortgages or deeds of trust on nontransient residential real property.

The issuer of the CMO places the mortgage-backed securities in trust for the benefit of bondholders as security for the repayment of the bonds. The bond issuer pledges enough mortgage-backed securities so that the income stream generated by the securities will adequately service the bond interest and principal payments. In the event of a default under the CMO, the bond principal is accelerated and the trustee is directed by the terms of the trust indenture to sell the mortgage-backed securities on the open market to satisfy the debt.

The auditor disallowed the taxpayer's deduction of interest earned on the bonds, because he concluded that the interest was not received "on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties" as required by RCW 82.04.4292. The taxpayer has paid the assessment in full and now seeks a refund of the tax assessed on the CMO interest. The sole issue for consideration is whether collateralized mortgage obligations

are primarily secured by first mortgages or trust deeds on nontransient residential properties.

TAXPAYER'S EXCEPTIONS:

The taxpayer's petition sets forth the following arguments:

We make reference to the earlier Dept of Revenue issue over the deductibility of interest income received from mortgage-backed securities, which are collateralized by pools of first mortgage real estate loans.

. . . , two thrift institutions received a letter from the State Attorney General's office that the Dept. of Revenue will recognize as an exemption from the Business and Occupations [sic] tax, interest received on GNMA, FHLMC, and FNMA securities.

We contend that Collateralized Mortgage Obligations and Real Estate Mortgage Investment Conduits (REMICs)¹ are a type of mortgage-backed security, which are designed to provide the investor the same safety and yield advantage associated with traditional mortgage-backed securities (such as Ginnie Maes, Freddie Macs and Fannie Maes). At the same time, CMOs are structured to provide more stable cash flows and more consistent investment performance.

Therefore, we contend that CMOs and REMICs should receive the same tax treatment as traditional mortgage-backed securities. The examiner's letter re-affirms that interest from "underlying securities may be tax exempt because it is received directly from loans primarily secured by first mortgages of trust deeds on nontransient residential properties."

¹ The taxpayer appears to state that REMICs are a separate type of bond. According to materials submitted by the taxpayer prior to the conference, a REMIC is a specific type of CMO that qualifies for special income tax treatment under Section 7701(a) of the Internal Revenue Code. All of the investments at issue are CMOs that also qualify for REMIC treatment. Inasmuch as CMOs and REMICs are not different instruments, this determination discusses only the business and occupation tax consequences of investment in CMOs without reference to REMICs.

Your reason for not allowing an exemption on CMO and REMIC interest appears to be based on the belief that ETB 460.04.146 infers that "for the interest to be deductible, the investment or loans must be received directly from the loans [sic]."² However, the Excise Tax Bulletin 460.04.146 states something much different. It states, "for the interest to be deductible, the investments or loans must be:

1. Primarily secured by first mortgages on trust deeds on
2. Nontransient residential properties

Although CMOs and REMICs (or any mortgage-backed security) did not exist at the time ETB 460.04.146 was written, we contend that the above statement (primarily secured) certainly fits the CMOs and REMICs. The word primary (original, fundamental, basic, first) definitely describes the nature of our security underlying these investments. Furthermore, since investors in these types of securities are providing funds for home financing, it would seem that the original intent of the State Legislature would have been to allow a deduction for interest received from CMOs and REMICs.

Furthermore, we feel that other thrift institutions in the State of Washington must have also invested in CMOs and REMICs. We request that we receive consistent treatment to that allowed other institutions.

(Emphasis in original.)

DISCUSSION:

[1] RCW 82.04.4292 provides the following business and occupation tax deduction:³

² Presumably, the taxpayer meant to state that the interest "must be received directly from the loans" rather than the "investment or loans."

³ Although the taxpayer's petition quotes an Attorney General's Office communication to say that RCW 82.04.4292 grants an

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. (Emphasis supplied.)

It is the position of the Department that mortgage-backed securities issued by GNMA, Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Corporation ("FHLMC") are primarily secured by first mortgages or trust deeds on nontransient residential properties. Accordingly, interest received by financial institutions from investment in these securities is deductible from the measure of the business and occupation tax. We have concluded that the primary security for these obligations is the underlying mortgages. Default by any borrower in the repayment of an underlying loan will give the security holder the rights to the proceeds of sale of the property in foreclosure. Although the repayment of the underlying loan is guaranteed by the issuer, we determined that the guarantors are only secondarily liable in the event foreclosure proceeds are insufficient to repay the defaulted loans.

CMOs differ from GNMA, FNMA, and FHLMC mortgage-backed securities in that they are an additional step removed from the right of foreclosure against the underlying real property. In the case of mortgage-backed securities, the issuing financial institution holds the mortgages in trust for the investor. Therefore, in the event of an individual default, the issuer, as trustee, forecloses on the property to satisfy the terms of the loan. Here, the obligation to repay the bond principal along with interest earned is separate and distinct from the borrowers' obligations on the underlying loans.

By contrast, the bond issuer secures its obligation by pledging readily tradeable securities in trust for the benefit of the bondholder. Upon default of the bonds, the bondholder's sole right is to require the trustee to sell the mortgage-backed security itself. The occurrence of an event of default under the terms of the trust indenture does not give the bond holder rights of foreclosure against the property securing the mortgage-backed security.

exemption from tax, it is clear from the language of the statute that it grants a deduction only.

CMOs are somewhat unique in that the expected source of repayment for the bonds comes from the collateral. It is conceivable that a mass default on the underlying mortgage loans could cause a default in the repayment of the bonds. Proceeds from the foreclosure and sale of the mortgaged properties could then be distributed to the bondholders. However, it does not necessarily follow that CMOs are primarily secured by the underlying property. Any failure by the trustee to make a scheduled bond payment would cause an event of default. An event of default on the bonds may or may not be tied to an individual default on an underlying mortgage loan. The bondholder is in a significantly different position from that of a holder of a mortgage-backed security. The bondholder's primary security is a readily tradeable investment instrument rather than a qualifying mortgage.

It is important to note that the taxpayer does not have an ownership interest in the mortgage-backed securities placed in trust as collateral. The taxpayer's interest is only in the proceeds of sale of the securities and then only in the event of default. The Department has consistently held that only the owner of a qualifying mortgage is entitled to the deduction under RCW 82.04.4292. See Det. 89-460, 8 WTD 241 (1989). Accordingly, we conclude that interest received on collateralized mortgage obligations is not deductible as amounts derived from interest received on loans primarily secured by first mortgages or trust deeds on nontransient residential property.

DECISION AND DISPOSITION:

The taxpayer's petition for refund is denied.

DATED this 24th of July 1990.