

Cite as Det. No. 93-086, 12 WTD 603 (1993).

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 Correction of Assessment of)	
)	No. 93-086
)	
. . .)	Registration No. . . .
)	. . ./Audit No. . . .
)	

- [1] RCW 82.04.4292 -- B&O TAX -- DEDUCTION -- MORTGAGE INTEREST -- REQUIREMENTS. The deduction available under RCW 82.04.4292 is available only when all of the following conditions are met: (1) The taxpayer is engaged in banking, loan, security, or other financial business; (2) the amounts received are derived from interest; (3) on an investment or loan; (4) primarily secured by a first mortgage or deed of trust; (5) on nontransient residential real property.
- [2] RCW 82.04.4292 -- B&O TAX -- DEDUCTION -- MORTGAGE INTEREST -- INTEREST ON SECOND TRUST DEEDS. Interest on loans secured by second trust deeds is not deductible from the measure of tax under RCW 82.04.4292. The taxpayer's reliance on an internal reference to all prior position liens on the real property is not sufficient to overcome the statutory restriction to interest on first trust deeds. PARTIAL ACCORD: Det. No. 80-121, 11 WTD 1 (1980).
- [3] RCW 82.04.4292 -- B&O TAX -- DEDUCTION -- MORTGAGE INTEREST -- "PRIMARILY" SECURED -- SECOND TRUST DEEDS. The deduction for interest on loans secured by first trust deeds does not extend to interest on loans secured by second trust deeds even when the taxpayer holds both the first and second trust deeds because the second loan is only tangentially secured by the first deed of trust.

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 TELEPHONE CONFERENCE: . . .

NATURE OF ACTION:

A bank protests the assessment of business and occupation taxes on its receipt of interest income on second mortgages and deeds of trust when the taxpayer holds the first mortgage or deed of trust. The taxpayer claims that interest income should be exempt from taxation under the provisions of RCW 82.04.4292.

FACTS:

Coffman, A.L.J. -- The taxpayer is a bank whose books and records were examined by the Department for the period of January 1, 1988 through September 30, 1991. The Department issued the above referenced tax assessment [showing] tax plus audit interest [owing]. The taxpayer made a partial payment . . . on the tax assessment and protested the balance, which remains unpaid.

The taxpayer is in the business of making of loans secured by real property. The taxpayer makes purchase money loans and takes first deeds of trust as security. Additionally, the taxpayer makes home improvement loans and takes second deeds of trust. The taxpayer submitted with its petition copies of its standard first and second trust deeds. The taxpayer uses the same form for a second trust deed whether the first trust deed is held by the taxpayer or by a third party.

The taxpayer's representative stated at the telephone conference that the process of making a home improvement or home equity loan is abbreviated when compared to a purchase money loan. When the taxpayer holds the first trust deed, it has the borrower's payment history and thus, a less extensive credit report is required. Likewise, the appraisal is usually a drive-by rather than a detailed appraisal. The taxpayer's representative stated that the second loan was looked at as an extension of the first loan by the taxpayer. The second loan and second trust deeds may be issued within a matter of months of the first trust deed or several years later.

ISSUE:

Is the taxpayer entitled to deduct interest it receives on loans secured by a second deed of trust when the taxpayer also holds the first deed of trust?

DISCUSSION:

The taxpayer claims that it is entitled to the benefit of the deduction found in RCW 82.04.4292, which reads:

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.

[1] To qualify for the deduction the following requirements must be satisfied:

1. the taxpayer must be engaged in banking, loan, security, or other financial business;
2. the amounts received are derived from interest;
3. the amounts derived from interest are 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 must create a security interest in nontransient residential real property.

Here, there is no question that the taxpayer meets the first requirement as a bank. Likewise, the amounts at issue were interest from loans and thus the second and third requirements have been met. The final requirement has been met because the property which secures the loan is nontransient residential real property. The question is whether the loans were "primarily secured" by first mortgages or deeds of trust.

We note that RCW 82.04.4292 is a deduction provision. As such it must be construed strictly in favor of taxation and against the deduction. See: Group Health Cooperative v. Tax Commission, 72 Wn.2d 422 (1967) and Budget Rent-a-Car v. Dept. of Rev., 81 Wn.2d 171, 174 (1972).

[2] The Department addressed this issue in Det. No. 80-121, 11 WTD 1 (1980). The Department held in that case that amounts received by a taxpayer on loans secured by second mortgages are not deductible even when the taxpayer held the first mortgage. The taxpayer attempts to distinguish that determination as follows:

[Taxpayer] does not believe that Determination 80-121 is applicable because the factual situation involved is distinguishable from the situation in Determination 80-121. The specific distinguishing point is described in the following quote from Determination 80-121:

"In response to questions from the hearing officer, the taxpayer testified that the note or contract covering the improvement loan contains no internal reference to the original mortgage or trust deed."

In the present situation, [taxpayer's] second trust deed has an internal reference to the first mortgage, which it also holds.

The taxpayer relies on paragraph [A] of its standard second deed of trust which states:

Prior Mortgages and Deed of Trust; Charges; Liens.
Borrower shall perform all of Borrower's obligations under any mortgage, deed of trust or other security agreement with a lien which has priority over this Deed of Trust, including Borrower's covenants to make payments when due. Borrower shall pay or cause to be paid all taxes, assessments and other charges, fines and impositions attributable to the Property which may attain a priority over this Deed of Trust, and leasehold payments or ground rents, if any.

(Emphasis added.)

The language does not mention the first deed of trust with any precision. The language is the same if the first trust deed is held by a third party. This paragraph only refers to possible claims that have priority over the second trust deed. The borrower's paragraph [A] obligation would exist even if the taxpayer did not hold the first deed of trust. Paragraph [A] is not an internal reference to the original mortgage; rather, it is a requirement to protect the security established by the second deed of trust.

Further, we do not believe that mention of "internal reference" in Det. No. 80-121, 11 WTD 1 (1980) was the deciding factor. The loans at issue in this case, as those discussed in Det. No. 80-121, 11 WTD 1 (1980) were secured by second trust deeds. The taxpayer could have sold the loans secured by the first or second trust deeds or sold participations in them. The loans secured by the second trust deeds are separate from the loans secured by the first trust deeds.

We find that the taxpayer's situation is identical in all material aspects to the facts found in Det. No. 80-121, 11 WTD 1 (1980).

The taxpayer argues in the alternative that the loan that resulted in the second deed of trust was primarily secured by the first deed of trust. The taxpayer bases this argument on the "internal reference" to the first trust deed found in paragraph [A] and the terms of paragraph [B] of the second trust deed. Paragraph [B] gives the taxpayer the right to foreclose on the property for any default which would include failure to make payments on the loan secured by the first trust deed. The taxpayer claims that because it can foreclose without having to pay off the first trust deed; the loan that gave rise to the second trust deed is primarily secured by the first trust deed. Further, the taxpayer claims that the second loan is merely an extension or continuation of the first loan.¹

The taxpayer relies on American Legion Post No. 32 v. City of Walla Walla, 116 Wn.2d 1 (1991). In that case the court construed the word "primarily" as it is used in the RCW 9.46.113, which authorizes local governments to impose a gambling tax that is to be "primarily" for enforcement of the gambling act. In that case the court stated that when it construes statutes it must attempt to carry out the legislative intent. In the situation in American Legion the court stated:

We find no support for the position that "primarily" means "for the most part" or "substantially". To attribute such interpretation to the term defies logic. Municipalities would be required to allocate at least 51 percent of the gambling tax to enforce the gambling act even if a lesser amount would suffice. In short, we would be attributing to the Legislature an intent that municipalities spend money even though it was not needed. Statutes must be interpreted to reflect their purpose and avoid absurd results.

(Emphasis added.) Id. at 9.

¹ We do not agree with this conclusion for several reasons. First, the interest rates charged by the taxpayer may not be the same. Second, although there is no time requirement in RCW 82.04.4292 relative to when the loans may be made, the lapse of sometimes long periods of time between the first and second loans is a strong indication that the second loan was not contemplated when the first loan was made.

The court in American Legion was concerned with the application of alternative definitions of the term "primarily" not the definition for all purposes.

The taxpayer's argument is that the term "primarily" means "essentially; mostly; chiefly; principally . . . in the first instance; at first; originally." American Legion, Id. at 8 quoting Random House Dictionary. The first trust deed states that it is for the purpose of securing the original loan. The second trust deed states that it is:

TO SECURE to Lender the repayment of the indebtedness evidenced by Borrower's note dated _____ and extensions and renewals thereof (herein "Note"), in the principal sum of U.S.\$_____, with interest thereon, . . .

The problem with the taxpayer's approach is that the borrower executes the second trust deed at the time the second loan is issued. The second loan is secured by the second trust deed not by the first trust deed. Thus, even if we were to accept the taxpayer's definition of the term "primarily" it would be of no assistance to the taxpayer. The terms of the second trust deed clearly demonstrate that it is the first security for the second loan. The second loan is only tangentially secured by the first trust deed, if at all. Therefore, the second loan is not primarily secured by the first trust deed. When the loan is not primarily secured by the first trust deed, the interest derived therefrom is not deductible under RCW 82.04.4292.

DECISION AND DISPOSITION:

The taxpayer's petition for correction of assessment is denied.

DATED this 12th day of March 1993.