

Cite as Det. No. 92-377, 13 WTD 222 (1994).

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. 92-377
)	
. . .)	Registration No. . . .
)	

- [1] RULE 146; RCW 82.04.4292: B&O TAX -- DEDUCTION -- INTEREST -- "MORTGAGE WAREHOUSING LOANS." Only the beneficial owner of a loan is eligible for the RCW 82.04.4292 deduction. Interest earned by bank on "mortgage warehousing" lines of credit debt are not deductible, even though first deeds of trust on "nontransient residential properties" were assigned to Taxpayer as collateral along with promissory notes from home buyers. The first deeds of trust secured only the payment of home buyers' promissory notes, and not the mortgage companies' obligations to Taxpayer under their warehousing agreements. Absent a default on the mortgage warehousing line of credit debt, Taxpayer had no beneficial interest in the home buyers' promissory notes and first deeds of trust; beneficial interest in these documents remained with the mortgage companies.
- [2] RULE 146; RCW 82.04.4292: B&O TAX -- DEDUCTION -- INTEREST -- HOUSING BONDS. Interest received on housing bonds is exempt when a fiduciary holds a first mortgage or deed of trust in the underlying qualifying properties and has the power to foreclose on behalf of the bondholders. The exemption will not apply when only the issuer of the bond is so secured.

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.

. . .

NATURE OF ACTION:

Petition concerning interest earned on loans made to mortgage companies and the taxability of interest received on state housing bonds.

FACTS:

Bauer, A.L.J. (as successor to Anne Roys and Robert Heller) -- Taxpayer is a bank.

Taxpayer earned interest from two categories of real estate related financing. Taxpayer characterizes both of these as loans or investments which were ultimately secured by first mortgages on nontransient residential property.

Mortgage Warehousing Lines of Credit. The first type of interest involved "mortgage warehousing" revolving lines of credit extended to mortgage companies for the purpose of providing working capital for real property loans to individuals.

In each of the revolving line-of-credit loans, a pre-existing lending relationship was established between Taxpayer and a mortgage company. Each of these relationships was memorialized by credit and security agreements between the parties, and a promissory note from the mortgage company to Taxpayer.

Interest rates payable to Taxpayer under these warehousing line-of-credit agreements, such as a floating rate related to "prime," were negotiated in advance. This interest rate would not necessarily reflect the lending rates negotiated between the mortgage companies and the mortgage companies' customers (hereinafter referred to as "home buyers").

In each instance, then, there were two loan obligations: The underlying mortgage obligation negotiated between the home buyer and the mortgage company, and the "warehousing" line of credit obligation between the mortgage company and Taxpayer.

Pursuant to the standard terms of the mortgage warehousing line-of-credit agreement, no credit would be extended to a mortgage company by Taxpayer except with respect to individual loans to be made by the mortgage company, which loans qualified under criteria outlined in the credit agreements. With funds extended by Taxpayer, the mortgage company would be able to, in turn, advance loans to home buyers.

According to Taxpayer, the mortgage companies would obtain promissory notes and first liens from the home buyers, such first

liens normally being deeds of trust. These notes and liens would be assigned to Taxpayer, along with an interest in other collateral, as one of the conditions of the bank advancing money on the mortgage companies' lines of credit. Such assignment was required under Taxpayer's "Security Agreement," which required security interests to be granted in order to secure the indebtedness of Borrower (the mortgage company) to Taxpayer. Home buyers' promissory notes and first deeds of trust were merely two of the items which secured the mortgage companies' obligations to Taxpayer under the "mortgage warehousing" lines of credit.

Payments made by home buyers were made to the mortgage companies, which continued to service the home loans until the mortgage companies packaged and sold the loans on the secondary mortgage market or to other investors as contemplated by their line-of-credit agreements. The mortgage companies paid interest to Taxpayer on its mortgage warehousing revolving line of credit debt monthly; principal was required to be paid when received by the mortgage companies.

A sample credit agreement executed by Taxpayer and a mortgage company contained the following provision:

3.1 Collateral. As security for the prompt payment and faithful performance of all of Borrower's obligations under this Agreement, the Revolving Note, each Special Item Note and all documents executed in connection with this Agreement, Borrower hereby grants to Bank a security interest in and to all of the following collateral:

(a) Mortgage Loans. All Mortgage Loans which have been assigned and pledged to Bank in connection with the making of an Advance under the Revolving Loan. All Mortgage Loans shall be assigned and pledged by Borrower to Bank by delivery of the following documentation:

(i) Collateral Transmittal Letter, with appropriate insertions;

(ii) Original promissory note, endorsed in blank;

(iii) Copy of the First Deed of Trust; and

(iv) Assignment of the First Deed of Trust in recordable form, with Bank to have the right but not the duty to record;

(Emphasis added.)

Although Taxpayer has represented that all loans under these mortgage warehousing line of credit debts were secured by first deeds of trust on nontransient residential housing, we are constrained to note that paragraph 2.1(b)-(d), Article II of the Credit Agreement provides that there could have been advances under the agreement made for "Land Development Loans (i.e., purchase of land or completion of infrastructure)," loans with no assignment/pledge of the underlying mortgage loans, and "Special Item Notes (i.e., promissory notes by the mortgage company to Taxpayer)."

Housing Bonds. The second type of interest at issue in this case was interest earned by Taxpayer on various housing authority bonds purchased and owned by Taxpayer as investments. These bonds were issued by various governmental housing agencies outside the state of Washington. The bond proceeds were used by the various issuers to finance the purchase of nontransient residential properties of certain identifiable types of buyers (such as veterans, low income, etc.).

Taxpayer has supplied this office with Official Statements regarding six different types of bonds it owned. These six are represented to be typical of the many other bonds owned.

ISSUES/TAXPAYER'S EXCEPTIONS:

Issue #1: Was interest earned by a bank on a mortgage company's revolving line-of-credit exempt under RCW 82.04.4292 when, as a condition of the line-of-credit agreement: (1) amounts extended under the line-of-credit were for the purpose of funding the purchase of nontransient residential properties by home buyers, i.e., working capital for home loans, and, (2) as a condition of each loan, home buyers' underlying promissory notes and first deeds of trust were assigned to the bank as security for payment of the mortgage company's line-of-credit debt.

Taxpayer argues that interest earned on mortgage warehousing loans is exempt, because Taxpayer had purchased all rights under the loans and the mortgage companies had assigned the promissory notes and first deeds of trust over to Taxpayer. Thus, Taxpayer had full rights under the mortgage, including the right to foreclose upon the real property in the event of default. Taxpayer argues that all requirements of RCW 82.04.4292 are present for exemption.

Issue #2: Is interest earned on housing bonds exempt under RCW 82.04.4292 when, as a condition of any such loan made, the loan is fully secured by first liens on the properties financed?

Taxpayer argues that interest received on housing bonds is fully secured by first lien interests in the residential properties purchased with such funds, since the housing authorities, on behalf of the bondholders, hold all rights of foreclosure under the mortgages.

DISCUSSION:

Issue #1 (Mortgage Warehousing Loans):

RCW 82.04.4292 provides an interest exemption for:

. . . those engaged in banking, loan, security or other financial businesses [of] amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties.

The facts in this case involve the endorsement in blank and delivery of promissory notes and the assignment of first deeds of trust securing these notes to Taxpayer. At first blush, these assignments appear to qualify Taxpayer-bank to exemption under RCW 82.04.4292.

[1] However, we conclude that the RCW 82.04.4292 deduction does not apply to interest earned on mortgage warehousing lines of credit debt for the following two reasons:

First, deeds of trust assigned to Taxpayer under these agreements secured only the payment of home buyers' promissory notes, and not the mortgage companies' obligations to Taxpayer under their line of credit agreements. Mortgage companies' lines of credit were secured in part by the home buyers' promissory notes, which only in turn were secured by first deeds of trust. The first deeds of trust could not be executed (or foreclosed) against unless the home buyers defaulted on their promissory notes. Absent that circumstance, Taxpayer could not execute against these deeds of trust if a mortgage company defaulted on its obligation under the line of credit agreement. Taxpayer's only remedy was then to assume the beneficial interest in the home buyers' promissory notes, in the nature of an account receivable, which in turn would then be secured by the first deed of trust. See Det. No. 90-288, 10 WTD 314 (1990).

Second, documentation supplied by Taxpayer clearly indicates that Taxpayer, at best, held only bare legal title as collateral to the home buyers' promissory notes and first deeds of trust as a result of their assignment. The beneficial interest in these instruments remained with the mortgage companies, who continued to service the mortgages and utilize these funds to pay their

debts to Taxpayer under their mortgage warehousing lines of credit. Only the beneficial - or "true" - owner of a loan or investment will receive the RCW 82.04.4292 deduction. See Det. No. 89-460, 8 WTD 241 (1989).

In this case, the home buyers' promissory notes were endorsed in blank and the accompanying deeds of trust were assigned to Taxpayer by mortgage companies in order to secure the payment of their own mortgage warehousing line of credit debts. Although Taxpayer has argued strenuously that total ownership of these instruments passed to Taxpayer as a result of this assignment, we disagree. Such transfers were clearly in the nature of a transfer of accounts receivable for collateral purposes only, and the first deeds of trust accompanying and underlying these promissory notes were security only for the payment of the individual home buyers' promissory notes.

The representative agreements presented to the Department by Taxpayer support this conclusion:

The Revolving Note shall be secured by a security interest in all Mortgage Loans assigned and pledged to Bank as set forth in Section 3.1(a), and a security interest in all accounts, instruments, chattel paper, contract rights and general intangibles relating to all such Mortgage Loans as set forth in Section 3.1(b).

[p.5, Article II, Credit Agreement.]

As security for the prompt payment and faithful performance of all of Borrower's [i.e., mortgage company's]. . . obligations under this Agreement, the Revolving Note, . . . Borrower hereby grants to Bank [i.e., Taxpayer] a security interest in and to all of the following collateral:

(a) Mortgage Loans. All Mortgage Loans which have been assigned and pledged to Bank in connection with the making of an Advance under the Revolving Loan. All Mortgage Loans shall be assigned and pledged by Borrower to Bank in connection with the making of an Advance under the Revolving Loan. All Mortgage Loans shall be assigned and pledged by Borrower to Bank by delivery of the following documentation:

(i) Collateral Transmittal Letter, with appropriate insertions;

(ii) Original promissory note, endorsed in blank;

(iii) Copy of the First Deed of Trust; and

(iv) Assignment of the First Deed of Trust in recordable form, with Bank to have the right but not the duty to record;

(b) Accounts, General Intangibles, and Other Loan Documentation. All accounts, instruments, chattel paper, contract rights, general intangibles consisting of, arising from, or related to Mortgage Loans assigned and delivered to Bank [etc].

[pp.9-10, Article III, Credit Agreement]

4.1 Trust Receipt. So long as no event of default as defined in Article IX shall occur or exist, Bank shall, at Borrower's request, return to Borrower an original promissory note, previously assigned and pledged to Bank pursuant to Section 3.1(a), provided Borrower is prepared at such time to transmit the promissory note, together with all required loan documents for such Mortgage Loan, to an Investor for purchase. Each promissory note shall be returned to Borrower subject to a Trust Receipt, which Borrower shall execute and deliver to Bank when the promissory note is returned to Borrower. Bank shall also return the original Assignment of Deed of Trust (or reassignment if the Assignment of Deed of Trust has been recorded). . . . As stated in the Trust Receipt, Borrower shall instruct the Investor to remit payment free of all offsets or counterclaims directly to Bank by wire transfer, in immediately available funds, Bank agrees that if a Mortgage Loan is part of a pool, which contains loans pledged to other lenders, the Investor payment may be made directly to the account of Borrower at another bank, provided that Borrower promptly upon receipt of such payment makes the principal payment under the Revolving Loan as required

[pp. 10-11, Article IV, Credit Agreement.]

Clearly, the beneficial ownership of these instruments (i.e., the promissory notes and the first deeds of trust) continued to reside in the mortgage companies, absent any default on their lines of credit. This is because: (1) any assignment/transfer was of legal title only to secure the mortgage companies' debts under their warehousing line of credit agreements, (2) payments by home buyers on their mortgages were collected by the mortgage companies and then used to reduce their debts to Taxpayer, and (3) by agreement, the mortgage companies - and not Taxpayer - sold these loans on the secondary mortgage market or to investors in order to pay off their warehousing line of credit debt.

The Department construes contracts so that all their terms are consistent. In this case, the warehousing line of credit contract terms clearly imply that the mortgage company retained beneficial interest in the Deeds of Trust and promissory notes. Otherwise, the mortgage company could not collect payments thereon on their own behalf or sell the loans on the secondary market. Interpreting the assignment of the first deeds of trust and promissory notes to Taxpayer as the transfer of mere legal title is consistent with the other contract terms. Therefore, we find that the mortgage companies retained beneficial ownership of the loans, including the deeds of trust, in question.

The mortgage companies, as beneficial owners of the home buyers' promissory notes, continued to be secured by the first deeds of trusts collateralizing these notes. As beneficial owners, only the mortgage companies were entitled to the RCW 82.04.4292 deduction. It could not have been the intent to simultaneously extend the same deduction to both the legal and beneficial owners of a loan when such ownership interests are split between two taxpayers. As stated in Det. No. 89-268, 7 WTD 359 (1989):

Exemptions to a tax law must be narrowly construed. Yakima Fruit Growers Ass'n v. Henneford, 187 Wash. 252 (1936). Taxation is the rule and exemption is the exception. Fiberboard Paper Prods. Corp. v. State, 66 Wn.2d 87 (1965). Where a statute specifically designates the things upon which it operates, there is an inference that the legislature intended all omissions. Wash. Natural Gas v. P.U.D. 77 Wn.2d 94 (1969), Queets Band of Indians v. State, 102 Wn.2d 1 (1984). Anyone claiming a benefit or deduction from a taxable category has the burden of showing that he qualifies for it. Group Health Coop. of Puget Sound, Inc. v. State Tax Comm'n, 72 Wn.2d 422 (1967). Exemptions thus do no more than carve out a narrow niche where the tax law does not reach. Budget Rent-A-Car v. Dep't of Rev., 81 Wn.2d 171 (1972).

Accordingly, we hold that a taxpayer who retains merely a legal interest - as opposed to a beneficial interest - in a mortgage for security purposes is not entitled to the RCW 82.04.4292 deduction. Interest thus received by Taxpayer on its mortgage warehousing lines of credit could not be deducted because Taxpayer did not possess a beneficial interest in the loans (promissory notes) secured by first deeds of trust. To the extent this holding is inconsistent with prior . . . Departmental determinations, those determinations are hereby overturned.

Issue #2 (Housing Bonds):

As to the second issue, the provisions of each bond will have to be examined to determine whether interest paid to bondholders is exempt under the provisions of RCW 82.04.4292. For example, the housing bond Official Statements submitted by Taxpayer provide in part as follows:

EXAMPLE #1

\$100,000,000

[A] Housing Finance Corporation,
State Guaranteed Bonds, 1983 Fourth Series
(Veterans Mortgage Program).
Dated August 1, 1983.

The Revised Preliminary Official Statement dated [July 1983] provides in part that each of the underlying deeds of trust of properties purchased by veterans under this program will "expressly recite the interest of the Trustee on behalf of the holders of outstanding bonds". . . (page 19).

EXAMPLE #2

\$100,000,000

[A] Housing Finance Corporation
Home Mortgage Bonds, 1982 Second Series
Dated November 1, 1982.

The Official Statement dated [November 1982] provides that "each mortgage deed of trust relating to the Mortgage Loans purchased from the proceeds of the bonds will expressly recite the interest of the Trustee on behalf of the holders of outstanding bonds of the Corporation in the mortgaged property" (page 25). Thus, the Trustee holds a first deed of trust in the underlying property with the power to foreclose on behalf of the bondholders. These bonds are not general obligations of the state

EXAMPLE #3

\$100,000,000

[B] Housing Finance Agency
Multi-Unit Rental Housing Revenue Bonds, 1979 Series A
Dated August 1, 1979.

The Preliminary Official Statement [dated July 1979] regarding these bonds provides that the first Deed of Trust will be in the name of the [B] Housing Finance Agency, and that if a Borrower defaults in the payments on a Loan, the Agency may institute foreclosure or other recovery proceedings (page 11). These bonds are not general obligations of the state

EXAMPLE #4

\$20,000,000

[A] Housing Finance Corporation

Insured Mortgage Program Bonds, 1976 First Series
Dated August 1, 1976

The Preliminary Official Statement [dated July 1976] provides that the originating institution will furnish to the [A] Housing Finance Corporation the mortgage deed and an assignment thereof. Only the Corporation, then, holds the first mortgage and the power to foreclose (page 12). Although a Trustee does have certain enumerated powers to enforce payment on the bonds (page 28), foreclosure on the mortgages on behalf of the bondholders is not one of them.

EXAMPLE #5

\$17,740,000

[C] General Obligation Bonds

State Housing Division Elderly Housing Bonds, 1982 Series A
and

\$6,365,000

[C] General Obligation Bonds

State Housing Division Elderly Housing Bonds, 1982 Series B

Date of Sale: May 4, 1982

Although the Preliminary Official Statement [dated April 1982] does not specifically address who will hold the first lien deed of trust, page 13 provides ". . . in the event of foreclosure of a Mortgage Loan, or assignment or sale of the development to the [State Housing] Division in lieu of foreclosure. . . ." This indicates that the State Housing Division - and not a trustee on behalf of the bondholders - holds the first mortgage or Deed of Trust and the power to foreclose.

EXAMPLE #6

\$150,000,000

[C] General Obligation Bonds

. . . Veterans' Welfare Bonds, Series LIV

Date of Sale: April 11, 1978

Although the Preliminary Official Statement dated [March 1978] provides that all loans are secured by first liens on the mortgaged properties (page 8), there is no indication that such first lien is held by a fiduciary which can exercise the power to foreclose on behalf of the bondholders.

Of the above, Examples #1 and #2 provide for a trustee to hold a first lien mortgage or deed of trust on behalf of the bondholders. Because Taxpayer in this case, as a bondholder in Examples 1 and 2, can be construed to be primarily secured by a first lien mortgage or deed of trust through a fiduciary, interest on these bonds will be exempt from Washington's B&O tax under RCW 82.04.4292.

In the remaining examples, only the issuing agencies of the bonds are so secured. The bondholders - themselves or through a fiduciary - are not primarily secured by first mortgages or deeds of trust.

It is noted that the fact that a bond may or may not be a general obligation bond is not dispositive of the RCW 82.04.4292 exemption. The RCW 82.04.4292 exemption derives from the existence and nature of the security interest held by either Taxpayer or by a fiduciary on Taxpayer's behalf.

[2] Therefore, interest received on housing bonds will be exempt under RCW 82.04.4292 when a fiduciary or trustee on behalf of the bondholders, who have a beneficial interest in these documents, holds a first mortgage or deed of trust in nontransient residential properties. The exemption will not apply when the issuer of the bond is so secured.

DECISION AND DISPOSITION:

Taxpayer's petition is granted in part and denied in part:

Issue #1: Taxpayer's request for refund of taxes paid on interest collected on its mortgage warehousing lines of credit is denied.

Issue #2: Taxpayer's request for refund of taxes paid on interest collected on housing bonds is granted in part and denied in part. The Audit Section will coordinate with Taxpayer to review its housing bond documents in order to ascertain the amount of refund due for overpayment of taxes on housing bond interest using the test enumerated above.

Statutory interest will be paid on all refund amounts.

DATED this 21st day of December 1992.