

Cite as Det. No. 13-0212, 33 WTD 125 (2014)

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition for	)	<u>D E T E R M I N A T I O N</u>
Correction of Assessment of	)	
	)	No. 13-0212
. . .	)	
	)	Registration No. . . .
	)	

[1] RULE 146(3); RCW 82.04.4286: SERVICE AND OTHER ACTIVITIES B&O TAX – BANKS, INTEREST INCOME – “FANNIE MAE”, “FREDDIE MAC.” Interest earned by banks on securities issued by the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) (“Fannie Mae”, and “Freddie Mac”) is received from government sponsored enterprises (GSEs). These GSE payments do not represent tax exempt direct obligations of the Federal Government, and are subject to B&O tax.

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.

Munger, A.L.J. – The Taxpayer, a bank, appeals the assessment of Business and Occupation Tax on its interest income received from the government sponsored enterprises Fannie Mae and Freddie Mac. Because these payments do not represent tax exempt direct obligations of the federal government, we affirm the assessment.<sup>1</sup>

### ISSUE

Is interest received on the security obligations of Fannie Mae and Freddie Mac after the 2008 conservatorship a direct obligation of the federal government and thus deductible from gross income per WAC 458-20-146(3)?

### FINDINGS OF FACT

The Taxpayer . . . is a . . . Washington-based bank. The Taxpayer was audited by the Department of Revenue (Department) for the January 1, 2008, through September 30, 2011,

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<sup>1</sup> Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

period. The issue on appeal relates to the largest portion of the audit assessment issued June 19, 2012. [A portion] . . . of the [total] . . . assessed consists of Service and Other Activities Business and Occupation (B&O) Tax. This tax was applied to the Taxpayer's gross income received from the payment of interest on securities issued by Fannie Mae and Freddie Mac. The Taxpayer had deducted this income when reporting its gross income on its excise tax returns, believing it to be tax exempt under WAC 458-20-146(3). The assessment remains unpaid.

## ANALYSIS

### Federal Background

In this determination we will refer to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation by their commonly used names of "Fannie Mae" and "Freddie Mac."

Both Fannie Mae and Freddie Mac are government-sponsored entities (GSEs) established by Congress as federally chartered, shareholder-owned companies, to remain in existence until dissolved by Congress.<sup>2</sup> Fannie Mae was founded in 1938 during the Great Depression as part of the New Deal. Fannie Mae has been a publicly traded company since 1968. The corporation's purpose is to expand the secondary mortgage market by securitizing mortgages in the form of mortgage-backed securities.<sup>3</sup> Freddie Mac was created in 1970 to expand the secondary market for mortgages in the United States. Freddie Mac buys mortgages on the secondary market, pools them, and sells them as mortgage-backed securities to investors on the open market.<sup>4</sup> As housing GSEs, Fannie Mae and Freddie Mac have a public mission to provide stability and increased liquidity of the residential mortgage market, and to help increase the availability of mortgage credit to low and moderate income families.<sup>5</sup> Fannie Mae and Freddie Mac engage primarily in two forms of business: guaranteeing residential mortgage securities and investing in portfolios of residential mortgages.<sup>6</sup> See *County of Oakland v. Federal Housing Finance Agency*, 716 F.3d 935, 937 (6<sup>th</sup> Cir. 2013). GSEs hold or pool approximately \$5 trillion worth of mortgages.<sup>7</sup>

In 2008, as a result of stress in the mortgage markets, Congress enacted the Housing and Economic Recovery Act (HERA) of 2008, which created the Federal Housing and Finance

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<sup>2</sup> 12 U.S.C. § 1717(a); see Office of Management & Budget, *Budget of the United States Government, Fiscal Year 2012*, Appendix, Section 95, Government-Sponsored Enterprises at 1319-1320, <http://m.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/gov.pdf> (last accessed 7-9-13). In referring to GSEs, OMB states that: "These enterprises were established and chartered by the Federal Government for public policy purposes. They are not included in the Federal Budget because they are private companies, and their securities are not backed by the full faith and credit of the Federal Government."

<sup>3</sup> See <http://www.fanniemae.com/resources/file/aboutus/pdf/fm-amended-charter.pdf> and <http://www.fanniemae.com/portal/about-us/company-overview/about-fm.html>.

<sup>4</sup> See <http://www.freddiemac.com/governance/pdf/charter.pdf> and [http://www.freddiemac.com/corporate/company\\_profile/](http://www.freddiemac.com/corporate/company_profile/).

<sup>5</sup> 12 U.S.C. § 1716.

<sup>6</sup> 12 U.S.C. § 1717(b).

<sup>7</sup> See [http://en.wikipedia.org/wiki/Government\\_sponsored\\_enterprise](http://en.wikipedia.org/wiki/Government_sponsored_enterprise).

Agency (FHFA) to provide increased regulation of Fannie Mae and Freddie Mac, and to authorize the U.S. Department of Treasury to provide assistance to the housing GSEs.<sup>8</sup> HERA also authorized the FHFA to appoint itself as conservator of the GSEs and thereby succeed to all rights and powers of the GSEs, including ownership of assets, to keep the GSEs in safe and solvent conditions.<sup>9</sup> *County of Oakland*, 716 F.3d at 937 - 938.

On September 7, 2008, the FHFA director James B. Lockhart III announced he had put Fannie Mae and Freddie Mac under the conservatorship of the FHFA.<sup>10</sup> It was one of the major financial events in the ongoing subprime mortgage crisis. As of the start of the conservatorship, each GSE contracted to issue common stock warrants representing a U.S. Government ownership stake of 79.9%, at an exercise price of one-thousandth of a U.S. cent (\$ .0.00001) per share.

The Fannie Mae and Freddie Mac prospectuses for mortgage-backed securities contain the following text, or something virtually identical, in bold letters, and have since before the subprime loans were originated: "Neither the certificates nor interest on the certificates are guaranteed by the United States, and they do not constitute a debt or obligation of the United States or any of its agencies or instrumentalities other than Fannie Mae."<sup>11</sup> A 2010 prospectus used the following language:

We alone are responsible for making payments under our guaranty. The certificates and payments of principal and interest on the certificates are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any of its agencies or instrumentalities other than Fannie Mae.<sup>12</sup>

### Washington State Taxation

Washington State's B&O tax on banks does not contain a specific statutory exemption for interest earned on notes, loans or other obligations of the federal government. The statutory basis for the deduction relied upon by Taxpayer is RCW 82.04.4286, which allows a deduction 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."

For example, in the present Taxpayer's audit, the Department did not tax the Taxpayer's income received from Federal Home Loan Bank bonds and debentures because 12 U.S.C. § 1433

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<sup>8</sup> Housing and Economic Recovery Act (HERA) of 2008, 12 U.S.C. § 4617, *et seq.*

<sup>9</sup> 12 U.S.C. § 4617.

<sup>10</sup> Statement by Secretary of the U.S. Department of Treasury, Henry M. Paulson, Jr., on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers, September 7, 2008. <http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx> (last accessed 7-11-13); FHFA "Questions and Answers on Conservatorship," [http://www.treasury.gov/press-center/press-releases/Documents/fhfa\\_consrv\\_faq\\_090708hp1128.pdf](http://www.treasury.gov/press-center/press-releases/Documents/fhfa_consrv_faq_090708hp1128.pdf) (last accessed 7-9-13).

<sup>11</sup> [http://en.wikipedia.org/wiki/Government-sponsored\\_enterprise#cite\\_note-9](http://en.wikipedia.org/wiki/Government-sponsored_enterprise#cite_note-9). See for example the 2002 Fannie Mae prospectus: [http://www.fanniemae.com/syndicated/documents/mbs/remicpros/SF\\_FM\\_May\\_1\\_2002.pdf](http://www.fanniemae.com/syndicated/documents/mbs/remicpros/SF_FM_May_1_2002.pdf).

<sup>12</sup> See: [http://www.fanniemae.com/syndicated/documents/mbs/remicpros/SF\\_FM\\_May\\_1\\_2010.pdf](http://www.fanniemae.com/syndicated/documents/mbs/remicpros/SF_FM_May_1_2010.pdf).

specifically prohibits states from taxing this income. By contrast, there is no Federal statute preventing the state taxation of interest payments received from Fannie Mae and Freddie Mac.

WAC 458-20-146 (Rule 146) explains how the RCW 82.04.4286 B&O tax deduction applies to income earned by banks and other financial businesses as follows:

The deductions generally applicable to financial businesses include the following:

. . .

(3) Interest received on obligations on the state of Washington, its political subdivisions, and municipal corporations organized pursuant to the laws thereof. (RCW 82.04.4291). *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 (emphasis added). Examples of direct obligations of the federal government would include: Treasury bills, Treasury notes, Treasury bonds, and U.S. Savings Bonds. In Det. No. 89-476, 8 WTD 271 (1989) the taxpayer received interest income from a federal reserve bank attributable to its interests in federal securities (mostly treasury bills). We held that this income, paid as a direct obligation of the federal government, was properly excluded from state taxation.

By contrast, the GSEs at issue here, Fannie Mae and Freddie Mac, are not *directly* part of the federal government. The current conservatorships temporarily give the federal government a majority share of these companies, but they are still partially publicly owned companies, not branches of the federal government itself. In the current economic downturn, the federal government also bailed out General Motors, a publicly traded company.<sup>13</sup> Temporarily, the federal government owned a 61% share of GM. This did not make GM a branch of the federal government.

In this factual context, we also note the following requirements when considering the Rule 146(3) tax deduction. . . . The Taxpayer has the burden of proving qualification for tax exemptions or deductions. *Group Health Co-op. v. Tax Comm'n*, 72 Wn.2d 422, 43 P.2d 201 (1967). *Tesoro Refining & Marketing Co. v. Dep't of Revenue*, 164 Wn.2d 310, 317, 189 P.3d 28 (2008). Exemptions from a taxing statute must be narrowly construed. *Budget Rent-A-Car, Inc. v. Dep't. of Revenue*, 81 Wn.2d 171, 174, 500 P.2d 764 (1972); *Evergreen-Washelli Memorial Park Co. v. Dep't. of Revenue*, 89 Wn.2d 660, 663, 574 P.2d 735 (1978).

Under Rule 146, only interest from “*direct obligations of the federal government*” may be deducted for Washington’s B&O tax purposes. Rule 146(3). Given the explicit disclaimers of a federal guarantee on the obligations, it would be difficult to find that these were even indirect obligations of the federal government. . . . Strictly construing the Rule 146(3) deduction, we find the evidence does not support the Taxpayer’s claim that Fannie Mae’s and Freddie Mac’s interest payments were the “direct obligations of the federal government.”

<sup>13</sup> [http://en.wikipedia.org/wiki/General\\_Motors#Chapter\\_11\\_reorganization](http://en.wikipedia.org/wiki/General_Motors#Chapter_11_reorganization)

**DECISION AND DISPOSITION**

Taxpayer's petition is denied.

Dated this 12<sup>th</sup> day of July 2013.