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Deductibility of Interest Received on Investments or Loans Primarily Secured by First Mortgages or Trust Deeds on Nontransient Residential Properties

Purpose The purpose of this Excise Tax Advisory (ETA) is to provide guidance on the business and occupation (B&O) tax deduction for interest received on loans or investments secured by a first mortgage or deed of trust.

Requirements RCW 82.04.4292(1) allows the following deduction from B&O tax:

In computing tax there may be deducted from the measure of 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.

A taxpayer may deduct interest under RCW 82.04.4292(1) only if it meets all the following elements:

- (1) The taxpayer is engaged in banking, lending, securities, or other financial business,
- (2) The amount received is interest,
- (3) The amount received is from either a loan or investment,
- (4) The loan or investment is primarily secured by a first mortgage or deed of trust, and
- (5) The property serving as security is nontransient residential property.

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**10 State
Limitation**

In addition to the above requirements, a taxpayer cannot take the deduction if:

- The taxpayer is located in more than 10 states; or
- The interest is received from loans that were originated by a person located in more than 10 states.¹

For purposes of this limitation, a person (taxpayer or otherwise) is located within a state if the following applies to the person's presence in the state:

- The person, or an affiliate, has a branch, office, or one or more employees or representatives located in the state, and
- As a result of that in-state presence, borrowers or potential borrowers are able to contact the branch, office, employee, or representative for purposes of acquiring, negotiating, renegotiating, restructuring, or making payments on mortgages issued or to be issued by the person or an affiliate of the person.²

An affiliate, for purposes of the limitation, means an entity under common control with the person.³

**"Other
Financial
Business"**

A taxpayer other than a banking, lending, or securities business may qualify for the deduction only if it is a financial business. A financial business is one that:

- (1) Primarily earns income through utilizing significant cash outlays, and
- (2) Is comparable to a banking, lending, or securities business.⁴

Interest

For purposes of this deduction, interest means the following:

- The fee charged for the use or forbearance of money, and
- The portion of fees charged to borrowers, such as points or loan origination fees, that are recognized over the life of the loan as an adjustment to yield.⁵

The gain on the sale of any loan or investment is not interest.

**Primarily
Secured by**

The deduction in RCW 82.04.4292(1) is only available if the interest income is received from an investment or loan primarily secured by a first mortgage or deed

¹ RCW 82.04.29005(1); RCW 82.04.4292(5).

² RCW 82.04.29005(2).

³ RCW 82.04.29005(3)(a); RCW 82.04.645(2). "Control" means the possession, directly or indirectly, of more than 50% of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting shares, by contract, or otherwise.

⁴ See Det. No 15-0027, 34 WTD 577 (2015).

⁵ RCW 82.04.4292(2).

**First Mortgage
or Deed of
Trust**

of trust. To meet this requirement, the taxpayer must have a right to the direct proceeds from the foreclosure on a defaulting borrower's property.

Persons investing in mortgage-backed securities⁶ generally lack the right to the direct foreclosure proceeds when a borrower defaults. An investor who does not have this right will not qualify for the deduction:

- An investor in a mortgage-backed bond (MBB), a collateralized mortgage obligation (CMO), or a real estate mortgage investment conduit (REMIC) does not qualify for the deduction. These investments are not primarily secured by first mortgages or deeds of trust because the investor does not have legal recourse to the underlying assets if the borrower defaults.⁷
- Investors in mortgage pass-through securities (often called certificates) may qualify for the deduction. Mortgage pass-through securities (unlike MBBs, CMOs, and REMICs) represent a fractional undivided interest in a fixed pool of mortgage loans. Investors in mortgage pass-through securities typically have a beneficial ownership interest in the underlying loans making up the pool. But to qualify for the deduction, the payments pass-through investors receive must be tied directly to the actual payments borrowers make and may vary month-to-month. Qualifying investors have a corresponding right to the actual foreclosure proceeds in the event of default (i.e., the trustee can foreclose and the proceeds from foreclosure flow directly to the investors).⁸

Interest on secondary or subordinate mortgages or deeds of trust is not deductible even if the taxpayer is the lender for both the primary and secondary loans.⁹

**Nontransient
Residential
Property
Requirements**

A property's status as nontransient residential property turns on the characteristics of the property and how the property is used.

Zoning and properties used for business purposes

Nontransient residential property only includes the following:

- (1) Property zoned for residential use with a residence located on it.

⁶ "Mortgage-backed securities" consist of a variety of financial instruments governed by different terms. Often these terms provide that an investment's assets are ultimately secured by mortgages, but that alone does not mean that a particular security provides its investors with the requisite level of recourse against those underlying mortgages. This is usually true in cases where an investor receives guaranteed payments (i.e., does not bear borrower credit risk). An investor's level of recourse is usually stated in a prospectus or similar financial document circulated to potential investors.

⁷ See *Cashmere Valley Bank v. Department of Revenue*, 181 Wn.2d 622, 334 P.3d 1100 (2014).

⁸ *Id.* See also Det. No. 89-460, 8 WTD 241 (1989); Det. No. 90-288, 10 WTD 314 (1990).

⁹ See Det. No. 93-086, 12 WTD 603 (1993).

- (2) Property zoned for residential use without a residence currently located on it, but subject to a commitment¹⁰ or requirement on the borrower to construct nontransient residences on the property.
- (3) Property not zoned for residential use, but containing a residence, the value of which exceeds the value of the non-residential portion of the property.

If property is used for both residential and business purposes, the deduction will only apply if the value of the property used for business purposes does not exceed 20% of the total value of the property. This requirement applies regardless of zoning status.

General use requirements

Transient housing generally means housing furnished to a person under a license to use real property.¹¹ In contrast, nontransient housing generally means property where housing is provided to the occupant with an exclusive right of continuous possession.¹²

Accordingly, nontransient residential property generally includes, but is not limited to, the following types of properties:

- Single family homes.
- Nontransient sites, including trailer park sites, for manufactured or mobile homes (where residency is 30 days or more and utilities are affixed/connected to the property).¹³
- Apartments.

The following types of properties are examples of transient housing because the occupant generally only possesses a license to use the real property rather than exclusive control or dominion over the property:

- Nursing homes (regardless of the length of occupants' stay).¹⁴
- Convalescent homes (regardless of the length of occupants' stay).
- Hotels.
- Motels.
- Transient apartments (under 30 days).
- Churches.

¹⁰ An investor may be required to provide reasonable evidence of a timely commitment or requirement to build.

¹¹ See RCW 82.04.050(2)(f); WAC 458-20-166(3). The granting of a license to use transient real property is distinguishable from the renting or leasing of real property to a nontransient tenant.

¹² See WAC 458-20-166 for more information on transient and nontransient housing. It is presumed that the occupancy of real property for a continuous period of one month or more constitutes a rental of real property and not a mere license to use or enjoy the same. RCW 82.04.050(2)(f).

¹³ See Det. No. 87-208, 3 WTD 245 (1987).

¹⁴ See *Lacey Nursing v. Department of Revenue*, 103 Wn. App. 169, 11 P.3d 839 (2000).

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- Undelivered manufactured or mobile homes (not affixed/connected).
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**Deduction for
Loan Servicing
Fees**

In addition to interest deductible under RCW 82.04.4292(1), RCW 82.04.4292(4) authorizes banking, loan, security, or other financial businesses to deduct amounts received for servicing loans primarily secured by first mortgages or trust deeds on nontransient residential properties.

A taxpayer may deduct loan servicing fees only if the following two conditions are met:

- (1) First, the person claiming the deduction must have either:
 - Originated the loans and either
 - (i) Sold the loans on the secondary market, or
 - (ii) Securitized the loans and sold the securities on the secondary market, *or*
 - Acquired the loan from the loan originator. If the taxpayer acquired the loan, it must either
 - (i) Be affiliated¹⁵ with the originator, or
 - (ii) Have acquired the loan through a merger with the originator or through an acquisition of substantially all the originator's assets.
- (2) Second, the amounts received for servicing must be:
 - Determined by a percentage of the interest paid by the borrower, and
 - Received only if the borrower makes interest payments.

Servicing fees that are not deductible include, but are not limited to, the following:

- Specific fees, such as document preparation, credit checks, notary services, loan application fees, finder fees, title examination fees, and similar fees.
- Commitment fees received in return for making funds available for a specific amount of time at specified terms.
- Any fees or portion of fees not recognized over the life of the loan as an adjustment to yield in the taxpayer's records according to generally accepted accounting principles (GAAP).
- Gains on the sale rights, such as amounts received when servicing rights are sold.¹⁶

¹⁵ For this purpose, "affiliated" means the taxpayer and loan originator are under common control. RCW 82.04.4292(4)(a)(ii)(A).

¹⁶ RCW 82.04.4292(3).

In addition to the above requirements, a taxpayer cannot deduct loan servicing fees if the taxpayer is located in more than 10 states. See discussion above for more information on this limitation.

Examples

The examples in the following section identify several facts and then state a conclusion. These examples should be used only as a general guide. The tax results of other situations must be determined after a case-by-case review of the facts and circumstances. Taxpayers who have questions regarding their activities may request a binding ruling from the Department.

Example 1 - RCW 82.04.4292(1)

- *Facts:* Simple Banking Co., a bank operating in three Northwest states with no affiliates, branches, employees, or representatives in other states, provides loans to developers and homebuyers. Lots securing the loans are residentially zoned and either have a single-family home constructed on the land or are contractually required to have a home constructed by the developer once a buyer is located. The bank secures its interest in each property through a primary mortgage and/or deed of trust.
- *Result:* Simple Banking Co. may deduct the interest earned on these loans. A construction loan for undeveloped residential property qualifies for the deduction if the borrower has a commitment or requirement to develop the property into nontransient residences.

Example 2 - RCW 82.04.4292(1); RCW 82.04.4292(5); RCW 82.04.29005(1)

- *Facts:* Same facts as Example 1, except Simple Banking Co. merges with Rocky Mountain Finance Corp., a nationwide lender and investor located in over a dozen states. The successor entity acquires all assets of both companies, including Simple Banking's mortgages/deeds of trust and Rocky Mountain's portfolio containing (1) construction loans made to a chain of hotels, and (2) a mortgage agreement backed by a deed of trust on a nursing facility.
 - *Result:* Because the successor entity is located in more than 10 states, any previously qualified investment or loan held by Simple Banking will lose its B&O tax deductibility. Even if the successor entity was located in 10 or less states, the entity could not deduct the interest earned from loans made to both the hotel owner and the nursing home operator because those types of properties do not meet the definition of nontransient residential property (rather, they reflect licenses to use transient real property).
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Example 3 – RCW 82.04.4292(1); RCW 82.04.4292(5); RCW 82.04.29005(1) & (2)

- *Facts:* Honolulu Holdings, Inc. is a financial business located in Hawaii. It has no affiliates, branches, or employees in any other states. Its real estate portfolio includes dozens of primary mortgages issued by the company, including deeds of trust on a number of residential properties located in Washington and 11 other U.S. states. The business utilizes a network of independent servicing companies to collect monthly payments from individual borrowers in all of those states. The companies may only accept loan payments and have no authority to restructure any existing loan terms.
- *Result:* Honolulu Holdings is considered to be located in more than 10 states because it has representatives in more than 10 states who can accept loan payments on its behalf. Because Honolulu Holdings is located in more than 10 states, it cannot deduct the interest from loans secured by these residential properties.

Example 4 – RCW 82.04.4292(1); RCW 82.04.4292(5); RCW 82.04.29005(1)

- *Facts:* Seattle Securities, LLC is a financial business located in Washington. The company is not located in any other states. The firm purchases primary home loans at a discount from banks on the secondary market. All of these loans originate from these same banks. Some of the banks are located in 10 or less states, while other banks are located across all 50 U.S. states.
- *Result:* Seattle Securities may only deduct the interest from loans that originated from banks which are located in 10 or less states. The loans acquired and originating from banks which are located in more than 10 states do not qualify for the deduction, regardless of whether Seattle Securities itself is located in 10 or less states.

Example 5 - RCW 82.04.4292(1)

- *Facts:* Open Air Lenders, Inc. is a financial business that also owns and operates trailer parks throughout Washington. The business is not located in more than 10 states. Open Air Lenders leases lots in its parks for a term of six months or more. To expand its trailer park operations, the company offers loans to its tenants to help facilitate the purchase of both new and used manufactured homes. In many cases, the new home purchased by a tenant is being fabricated and assembled off-site, to be delivered to the trailer park upon completion. In addition to the home purchase loans, Open Air Lenders also provides tenants with home equity lines of credit.
- *Result:* The interest Open Air Lenders receives from home purchase loans is deductible if that interest is from loans secured by manufactured homes that are already affixed to the site and connected to the site's utilities.

Interest from home purchase loans secured by manufactured homes that are undelivered or unconnected to utilities do not qualify for the deduction until the home is actually affixed to the site and connected to its utilities. Interest from the home equity lines of credit will only qualify if those loans are first, or primary home loans (i.e., there is no other mortgage or debt with priority).¹⁷

Example 6 - RCW 82.04.4292(4)

- *Facts:* Quick Homes, LLC originates short-term loans for low-to-moderate income homebuyers. The business is not located in more than 10 states. Quick Homes rapidly sells (securitizes) a 99 percent interest in each mortgage to investors. It keeps a minority one percent interest in the underlying loans and continues to collect monthly mortgage payments from the borrowers. Quick Homes retains one percent of the interest collected as a loan servicing fee and remits the remaining interest and principal amounts to the majority owners. It also separately charges each borrower a \$25 monthly fee for “loan processing.”
- *Result:* The proceeds Quick Homes receives in return from selling the 99 percent mortgage interests are not deductible under RCW 82.04.4292 as they represent gain from the sale of loans, not interest. But Quick Homes may deduct the one percent portion of interest payments it retains as a loan servicing fee. That fee is related to loans that Quick Homes originated and sold on the secondary market. Further, the fee is determined by a percentage of interest paid and is received only if that particular borrower makes a payment. Quick Homes’ “loan processing” fee is not deductible, as it is a flat fee not determined by a percentage of interest.

Example 7 - RCW 82.04.4292(1)

- *Facts:* Manny Faye is a federally sponsored entity which purchases home mortgages on the secondary market and pools them to create mortgage-backed securities it sells to investors. One type of security is called a “Guaranteed Mortgage Pass-Through Certificate.” According to the prospectus, these certificates represent a beneficial ownership interest in a pool of single-family residential mortgages. However, the prospectus also provides that (1) Manny Faye guarantees all investor payments, (2) Manny Faye and its trust are the parties exposed to the risk of losses and expenses related to borrower default, and (3) investors have only limited rights to bring proceedings against Manny Faye or the federal government in the event of Manny Faye’s failure to make payments.

¹⁷ A homeowner may, for example, use a home equity line of credit to pay off their existing mortgage, which may thereby place the line of credit in first priority on the home. If the borrower already has a mortgage and then takes out an additional line of credit, the interest on the line of credit would not be deductible.

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- *Result:* The interest received by investors who purchase these certificates is not deductible. A security is not considered pass-through merely because that term appears in its name. But even if this security has pass-through elements, these investors will not qualify for the deduction because they do not have recourse to the underlying mortgage assets. Although these securities are ultimately backed by residential mortgages, Manny Faye bears the credit risk while investors receive guaranteed payments. It is Manny Faye who has legal recourse to the foreclosure proceeds upon default, as investors are limited to bringing claims specifically against Manny Faye. Since these investors do not have an enforceable right against the individual properties backing the security, the security does not qualify for the interest deduction.¹⁸
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¹⁸ See Det No. 20-0061, 41 WTD 337 (2022).