STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
SUMITOMO TRUST AND BANKING CO. (USA)	:	DECISION DTA NO. 815381
for Redetermination of a Deficiency or for Refund of Franchise Tax on Banking Corporations under Article 32 of the Tax Law for the Years 1989 through 1991.	:	

Petitioner Sumitomo Trust and Banking Co. (USA), 527 Madison Avenue, New York, New York 10022-4304, filed an exception to the determination of the Administrative Law Judge issued on June 4, 1998. Petitioner appeared by Peter E. Pront, Esq. and Jerome R. Rosenberg, Esq. The Division of Taxation appeared by Terrence M. Boyle, Esq. (James P. Connelly, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a brief in opposition and petitioner filed a reply brief. Oral argument, at petitioner's request, was heard on March 11, 1999.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether, in determining entire net income, the Division of Taxation properly disallowed petitioner's Tax Law § 1453(e)(12) deduction of 22½ percent of the interest income generated by petitioner's Small Business Administration guaranteed loan pool certificates.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "7" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

Petitioner, Sumitomo Trust and Banking Co. (USA), is a New York State chartered trust company which was formed primarily to engage in the commercial banking business. Petitioner is subject to tax under Article 32 of the Tax Law.

As part of its operations, petitioner invests in various financial instruments. As is specifically relevant to this matter, petitioner's portfolio of investments during the years at issue included United States Small Business Administration ("SBA") guaranteed loan pool certificates ("Certificates"). There is no dispute between the parties that the SBA is an agency of the United States Government whose obligations are backed by the full faith and credit of the United States Government.

Petitioner described the Certificates as "Small Business Administration Notes", without further elaboration, on its Tax Law Article 32 returns for the years at issue. In computing its entire net income during the years 1989 through 1991, petitioner deducted 22½ percent of the interest income attributable to the Certificates. The Division of Taxation ("Division") conducted an audit of petitioner's books and records for the years 1989 through 1991. After requesting and receiving from petitioner additional information concerning the Certificates, and requesting and receiving an Opinion of Counsel from the Division's Office of Counsel concerning the deductibility of interest on the Certificates, the auditor disallowed petitioner's claimed 22½ percent deduction. In turn, the Division issued to petitioner a Notice of Deficiency, dated July

22, 1996, asserting additional tax due for the years 1989 through 1991 in the amount of $514,915.00, plus interest.[1] All audit issues other than the deductibility of 22½ percent of the interest earned on the Certificates have been resolved. Furthermore, the parties do not dispute the dollar amount of the asserted deficiency, but rather only whether such tax, the amount of which is driven entirely by the disallowance of the 22½ percent deduction, is in fact due.

The SBA's pooled loan program, which is part of the SBA's secondary market program, involves the grouping or "pooling" of the SBA guaranteed portions of various outstanding loans and the marketing of interests in such pools of loans. The loan pooling program, as described in the SBA's Secondary Market Program Guide, operates as follows:

> [a]n entity [a financial institution or a broker-dealer] desiring to be a pool assembler must first apply to SBA for approval using SBA Form 1455. After receiving such designation, the pool assembler collects loans to be placed in the pool. Once this process is complete, the assembler submits a pool application form (SBA Form 1454) to the FTA[2], along with the supporting documentation. Once the FTA has ascertained that the supporting documentation is correct and that the pool meets the requirements as to the minimum number of guaranteed portions, minimum aggregate dollar amount of a pool, minimum certificate size, and maximum permitted variation in note interest rates and terms to maturity, the FTA will issue the certificates representing interest(s) in the pool, in the amounts requested by the pool asssembler. The FTA will issue the certificates within forty-eight hours of settlement.

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[1] Validated consents with respect to the period of limitations on assessment were executed such that a notice of deficiency for the years in question could be issued at any time on or before December 15, 1996. The amount of tax at issue includes the franchise tax on banking corporations, imposed under Tax Law §1451(a), and the metropolitan transportation business tax surcharge ("MTBTS") imposed under Tax Law § 1455-B.

[2] The "FTA", or Fiscal and Transfer Agent, is an entity retained by the SBA, under contract, to perform accounting, registration, payment, transfer and other specified fiscal and administrative duties with respect to the SBA's secondary market programs.

> Assemblers who wish to hold the pool for their own investment portfolios will have certificates issued in their own names. Assemblers who have sold fractional or whole interests will have certificates issued in the buyers' names. Registered holders may sell their interests by completing the transfer form on the back of the certificate, being careful to comply with the disclosure requirements, and remitting the certificate to the FTA, which will issue a new certificate to the purchaser.

As described above, the pool assembler transfers documentation of the guaranteed portions of the loans to be included in the pool to the FTA, and directs the FTA to issue the Certificates to the investors. During the period at issue, Colson Services Corporation ("FTA" or "Colson") was the entity retained by the SBA, under contract, to serve as the SBA's Fiscal and Transfer Agent. The Certificates issued to each investor are trust certificates, per 15 USC § 634(g)(1), and represent each investor's share of beneficial ownership interest in the pool. Each investor is the registered owner of his or her Certificate, and a central registry of such owners is maintained for the SBA by Colson. The proceeds from the sale of the shares in the pool, less various allowable fees, go back to the original lenders. This method of pool assembling, marketing and purchase of outstanding loans by new investors thus serves, among other things, to promote the availability of funds for further lending. The Certificates are freely transferrable (i.e., an investor may sell or transfer its Certificate to another owner). Upon a transfer, the central registry is updated to reflect the new owner of the Certificate.

The original lenders continue to service the loans now included in the pool. The lenders are obligated to forward to the FTA (on the last business day of each month), the payments of principal and interest due and paid by the borrowers under the loans. A lender may be subject to a late payment penalty of five percent of the amount remitted late, or $100.00, whichever is

greater, capped at $5,000.00 per month, if payment is not timely received by the FTA from the lender. In turn, the amounts due the investors, per the Certificates, are paid on the 25th of each month (the "payment date") by the FTA to the certificate holders of record. The FTA will make the payments due to the investors on the payment date, whether or not it receives, from the servicing lenders, the payments owed by the underlying borrowers on the loans. The FTA will also remit, on the payment date, each investor's pro-rata share of any prepayments or early recoveries on any loans in the pool.

We modify finding of fact "7" of the Administrative Law Judge's determination to read as follows:

> There is a lag period between the time of initially purchasing a Certificate and the date of first payment thereunder. More specifically, there is a 70-day lag between the Certificate issue date and the date of first payment on fixed-rate Certificates, and there is an 85-day lag between such dates in the case of variable rate Certificates. The SBA has established a reserve account, which consists of the first principal payment that is received on each of the loans in a pool plus the investment income earned on such payments as thereafter invested by the SBA. In the event that the payments from the borrowers through the lenders to the FTA are insufficient to meet the amounts owed to the Certificate holders (i.e., some loans in the pool go unpaid when due or servicing lenders do not forward payments on time), the monies in this reserve fund are used by the FTA to make up any such shortfall.[3]

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[3] In contrast to the pooled loan program, the SBA also operates as part of its secondary market program an individual loan certificate program, under which a lender of an SBA guaranteed loan may sell the guaranteed portion of that loan to an individual investor. The lender, the investor and the FTA enter into a written agreement under which the lender agrees to service the loan and to forward payments from the borrower to the investor through the FTA. This program, unlike the pooled loan program, does not provide the investor with any guaranty of timely periodic payments on the payment due dates. If the borrower defaults for a period of 60 days, or if the lender fails to forward any payment to the investor through the FTA, then the investor may make a demand on the SBA, as guarantor, to repurchase the loan from the investor. Furthermore, and unlike the pooled loan program, the individual loan investor is entitled to have input on a borrower's request for a deferment in payments on its loan. The petitioner in this case invested only in the guaranteed loan pool certificates and did not invest under the individual loan certificate program.

> In the case of an individual loan certificate, the FTA will notify the registered holder of a prepayment or default. In contrast, if a particular borrower whose loan is in a pool prepays or defaults, the FTA will simply forward to each registered holder its pro rata share of the prepayment or, in the event of a default, its pro rata share of the SBA guaranty purchase amount. In instances where the SBA is required to pay as the result of borrower deferment or default, or lender failure, the SBA is subrogated to all of the investor's rights satisfied as the result of such payment.[4] [5]

As shown on an exemplar copy of a Certificate included in evidence, the Certificates carry on their face the heading "Guaranteed Loan Pool Certificate Guaranteed By Small Business Administration." Each Certificate lists its certificate number, issue date, maturity date, pool number, and registered holder (in this case petitioner), and sets forth the initial principal amount of the particular Certificate, the initial aggregate principal amount of the pool, and the interest rate. The terms and conditions of the Certificates are spelled out in eight separate paragraphs on the face of each Certificate. Such terms provide, *inter alia*, for the manner of calculation and payment of the Certificate in installments. Specifically, the second paragraph of the Certificate provides as follows:

> All installments shall apply first to interest at the interest rate designated above and then in reduction of the principal balance then outstanding, and shall continue until payment in full of the initial certificate principal amount, and of all interest accruing thereon. All payments to the registered holder hereunder shall be by a duly authorized fiscal and transfer agent.

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[4]In its exception, petitioner questioned the Administrative Law Judge's interpretation of 15 USC § 634(g)(5)(A), stating that the subrogation referred to therein referred to the SBA's rights in the event it has to make a payment to a lender pursuant to its guaranty to the lender of the borrower's repayment obligations. However, we believe the Administrative Law Judge correctly stated that the guaranty referred to was the one given to certificate holders in 15 USC § 634(g)(2) and that the SBA was subrogated to the "rights satisfied by such payment," i.e., those of the certificate holders. This was consistent with the Administrative Law Judge's conclusion that the SBA was merely the guarantor of the payment and not the primary obligor.

[5]We modified this finding of act by adding footnote "4" to more accurately reflect the record.

The third paragraph of the Certificate explains that the pool is comprised of guaranteed portions of various SBA guaranteed loans, that all such guaranteed portions are backed by the full faith and credit of the United States, and that the Certificate holder is the owner of an undivided beneficial interest in the pool (in the same proportion that the initial Certificate principal amount bears to the aggregate principal amount of the pool).

The fourth and fifth paragraphs of the Certificate provide, consistent with the guaranty on the face of the Certificate, as follows:

> Each monthly installment shall be adjusted to reflect any prepayments or other early or unscheduled recoveries of principal, received from time to time, under or consistent with the provisions of the guaranteed portions composing the pool. However, the fiscal and transfer agent shall remit monthly payments (whether or not collected by the lender) of not less than the amounts of principal coming due monthly on the guaranteed portions and apportioned to the registered holder, together with any apportioned prepayments or other early recoveries of principal, and interest at the interest rate designated above.
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> On the initial payment date commencing no later than the second month after the month in which the issue date occurs, the fiscal and transfer agent shall remit to the registered holder in whose name this certificate is registered its proportionate share of interest only. Thereafter, the fiscal and transfer agent shall remit monthly installments of principal and interest until payment in full of all amounts owing under this certificate has been made. Remittances shall be made to the registered holder by check, and final payment shall be made only upon surrender of this certificate. 'Payment date' means the date that checks are deposited in the U. S. mail by the fiscal and transfer agent. Such date is the 25th day of the month or the next business day if the 25th is not a business day.

The sixth and seventh paragraphs of the Certificate deal with the authority and role of the FTA, on behalf of the SBA, in executing documents, in maintaining the central registry of Certificate holders, and in handling the transfer and assignment of Certificates.

The eighth, and final, paragraph on the face of the Certificate provides as follows:

> Guaranty. The undersigned [SBA and by countersignature, FTA], pursuant to section 5(g) of the Small Business Act, hereby guarantees to the registered holder hereof the timely payment of the principal and interest set forth in the above instrument, subject only to the terms and conditions thereof. The full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under this guaranty.

Robert Bielunas, petitioner's senior vice-president and controller, testified concerning petitioner's decision to invest in the Certificates. He noted that petitioner was a small bank with an initial capitalization of twenty million dollars, and that capital preservation and timely receipt of payments on its investments as a means of predicting and controlling cash flow to meet payroll and rent obligations (among other expenses) were critical considerations for petitioner. Mr. Bielunas explained that the Certificates were thus attractive investments for petitioner, in terms of assuring capital preservation, because of the underlying SBA guaranty of the payment of the loans comprising the pool and, in terms of cash flow management for meeting expenses, because of the added guaranty of timely periodic payments on the payment date.

Mr. Bielunas alluded to a situation involving petitioner's parent bank, where certain investments thought to have been backed by the full faith and credit of the United States were not so backed, with resultant losses incurred after making such investments. Thus, Mr. Bielunas explained that he, on behalf of petitioner, conducted certain due diligence inquiries in order to confirm that the Certificates were backed by the full faith and credit of the United States. These

steps included his visit to the pool assembler (in this case the National Bank of Commerce in Memphis, Tennessee), inquiries to assure the legitimacy of the FTA (Colson), and a review of the Certificates and their terms. He also explained that the tax treatment of the Certificates, and specifically the issue of deducting 22½ percent of the interest earned thereon, was not a consideration at the time of petitioner's investment in the Certificates. In fact, this tax issue was not examined until after the close of petitioner's books and the issuance of its certified financial statements for the first year in which the Certificates were owned. At that point, petitioner's then tax advisors discussed that issue of deductibility. After additional review and inquiries, including a request by petitioner's legal counsel to the SBA for confirmation that the Certificates "are unconditionally and fully guaranteed by the full faith and credit of the United States," petitioner and its advisors made a determination that the deduction was appropriate.

Petitioner also presented testimony by John Cox concerning the SBA and its secondary market programs, including specifically the Certificates and, by comparison, the SBA's individual loan program. Mr. Cox worked for the SBA for 29½ years until his retirement in January 1997. His last position with the SBA was as Associate Administrator of Finance, where he was in charge of all of the SBA's financing programs for the nation, including secondary market sales, licensing of lenders and pool assemblers, agency collections, and all SBA matters having to do with finance. He has taught courses in secondary markets, both internally for the SBA and to lenders across the nation, is intimately familiar with the machinations and workings of the SBA and has testified as an expert regarding SBA programs and matters before numerous courts and before the Congress of the United States. Mr. Cox described the flow of funds in the pooled loan situation, as above, including the establishment and use of the reserve fund from

which the FTA is able to draw in order to pay the full amounts due each month under the Certificates even if some of the underlying borrowers fail to make payments to their servicing lenders or if some of the lenders fail to forward such payments to the FTA. He also described the role of the FTA as the SBA's agent with regard to the secondary market programs including, specifically, the pooled loan certificate program.

Mr. Cox explained that when the Certificate program was being set up, there was some discussion concerning whether all funds on the underlying loans being paid over by the servicing lenders should be paid in to the SBA and then paid back out to the Certificate holders. Mr. Cox stated that in order to avoid what was perceived to be a potential "accounting nightmare" due to lack of sufficient SBA personnel to handle the accounting and record keeping workload, the decision was made to use a fiscal and transfer agent to perform the accounting and payment functions and to maintain the central registry of Certificate holders. In turn, the SBA reserve fund was created as a source of funds to be available to the FTA, as needed, to cover any shortfalls in funds collected versus funds required to meet the timely monthly payment obligations under the Certificates. Mr. Cox noted the long-held belief and position that while the initial reserve fund deposits from any pool (i.e., the initial principal payments under the loans comprising the pool) are the investors' funds, the balance of the money in the reserve fund (i.e., investment returns earned on such initial deposits) is considered funds of the SBA and not of the investors. He also distinguished this reserve fund, which is available for purposes of meeting any "shortfalls" that would otherwise occur and impact the requirement of timely payment under the Certificates, from separate reserve funds maintained by the SBA and used to pay off the

underlying loans under the individual loan guarantee provision on each loan in the pool, in the event of borrower default, lender failure, or the like.

Mr. Cox explained that a default by a borrower causes the SBA, under its loan guaranty, to pay off the balance due on the loan. In the pooled loan situation, the lender has already been paid (from the investors' funds), and therefore SBA's payment into a pool upon a borrower's default would result in an early recovery. In turn, under the terms of the Certificates, such early recoveries would be paid over to the investors, pro rata, along with their monthly payments. Mr. Cox also testified about loans being in deferment status (known as "contract arrearage accounts"), where the SBA does not call a loan in the event of missed payments, but rather allows the borrower to cease making payments for a period of time so the borrower can recover and get back on a payment schedule. During such a deferment period, the FTA will draw from the reserve fund to cover the amounts needed to meet the payment obligations owed to the Certificate holders in a timely manner, notwithstanding the shortfall in amounts paid by the borrowers under their loans. Mr. Cox explained that if all borrowers made all payments as scheduled, without deferments or other failures, then there would be no need for the FTA to draw from the reserve fund. However, he noted that historically, at any given time, there is roughly a 20 percent shortfall between payments received by the FTA versus the amount required to be paid to the Certificate holding investors on the 25th of each month, with such shortfall made up from the reserve fund.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

After noting the deduction provided for in Tax Law § 1453(e)(12) regarding the interest income on obligations of the United States, excluding guaranties of the debt of a third party (20

NYCRR 18-2.4[b][12]), the Administrative Law Judge discerned that entitlement to the deduction was dependent on whether the certificates in issue were obligations of the United States, not merely guaranteed by the United States. The Administrative Law Judge found that the burden of proof rested with petitioner to establish its right to the deduction it is seeking (***citing Matter of Grace v. New York State Tax Commn***., 37 NY2d 193, 371 NYS2d 715, ***lv denied*** 37 NY2d 708, 375 NYS2d 1027).

The Administrative Law Judge thoroughly analyzed the case of ***Rockford Life Ins. Co. v. Illinois Dept. of Revenue*** (482 US 182, 96 L Ed 2d 152) where the United States Supreme Court held that Ginnie Maes, instruments issued by private financial institutions possessing a pool of federally guaranteed mortgages, were not exempt from state taxation since they were not direct and certain obligations of the United States, only backed by a secondary and contingent guaranty. The Court in ***Rockford*** noted that the United States was the guarantor not the obligor and did not bear the primary obligation to make timely payments. The Court in ***Rockford*** held that the Ginnie Maes did not possess the four requisite characteristics of obligations of the United States as set forth in ***Smith v. Davis*** (323 US 111, 89 L Ed 107), specifically, the requirement of a binding promise by the United States to pay specified sums at specified dates. The Court further held that such a contingent and unliquidated guaranty of the payments due was insufficient to invoke the constitutional protection against state taxation of federal obligations.

The Administrative Law Judge rejected petitioner's argument that the SBA certificates herein contained a direct promise to pay. The Administrative Law Judge noted that the individual borrower had the responsibility to continue repaying its loan to the lender, which in turn serviced the loan and forwarded payment to the trustee for the SBA. The trustee forwards

the payments owed to the SBA certificate holders in accordance with the terms of the certificates. The SBA merely made a guaranty that the amounts will be paid to the certificate holders regardless of whether there was a default in payment of the underlying obligations. Although increasing the appeal of the certificates as an investment, the guaranty did not change the SBA from a guarantor to a primary obligor. In fact, the certificates themselves state that the SBA is a guarantor.

The Administrative Law Judge reasoned that the guaranty of the SBA is contingent because if all loan obligations are met by the primary obligors and lenders, then the SBA will not be required to pay any monies to the certificate holders. Therefore, the certificates cannot be direct and certain obligations of the United States. The Administrative Law Judge found further support for his conclusion in the legislative history to the Small Business Secondary Market Improvements Act of 1984 (PL 98-352) which reflected that there was no intention to expend government funds on the pooling program.

In addition, the Administrative Law Judge found that the SBA's obligation to pass through prepayments or other early recoveries was indicative of a guarantor's responsibility, assuring the payment of the minimum amount due per the terms of the certificate, but not retaining or investing prepayments or other early recoveries for its own benefit.

The Administrative Law Judge opined that even though investors in the certificates may not be aware of the individual borrowers or servicing lenders, the reality is that the investors are not lending money to the government, but are buying a portion of a pool of private debt owed by various private borrowers, evidenced by an SBA issued certificate of ownership and backed by the guaranty of payment by the SBA. The SBA is a clearinghouse, issuing certificates evidencing

ownership in pools, keeping a central registry of such owners, collecting, accounting for and paying over the monies paid by the borrowers whose loans comprise each pool, and guaranteeing that such payments due the investors per the terms of the certificates will be made on time even in cases of breach or nonpayment. The Administrative Law Judge noted that the SBA's retention of the investors' first principal payments, earmarked specifically to "grow" a reserve fund to be available to the FTA to honor the timely payment guaranty, was consistent with his conclusion that the role of the SBA was as a guarantor which would make payments in the event its certificate holders would not receive their scheduled payments.

Further, the Administrative Law Judge held that the fact that the SBA becomes subrogated to the rights satisfied by any payments it makes under a guaranty, lends greater support to the conclusion that its role is one of guarantor and that the statutory authorization of 15 USC § 634(g) was implemented through the SBA's regulations, its Secondary Market Guide and in the terms set forth on the certificates.

ARGUMENTS ON EXCEPTION

Petitioner argues that the pooled loan certificates qualify for the deduction provided for in Tax Law § 1453(e)(12) because the SBA is the primary obligor with respect to the pooled loan certificates and not a guarantor. In support of this argument, petitioner points to the testimony and affidavits it submitted to the Administrative Law Judge in which SBA officials expressed their belief that the SBA was the primary obligor of the certificates. In addition, petitioner believed that the reserve fund, used to assist the SBA in funding the debt service not covered by payments from lenders with respect to loans, was indicative of its role of primary obligor, since

such fund was made up of the first principal payments on the loans and proceeds of investments made and owned by the SBA.

Petitioner also contends that federal tax law supplies guidance that supports treating the SBA as a primary obligor. Specifically, petitioner analogizes between pool certificates and the SBA's participating security programs, which were the subject of two private letter rulings of the Internal Revenue Service ("IRS") and a revenue ruling, Rev. Rul. 97-3. Looking to the substance of the transaction, the IRS found that the rights guaranteed by the SBA represented a primary obligation secured by a portion of the SBA's interest in distributions from the small business investment companies.

Petitioner argues that the Division has ruled that New York State and other federal obligations with flows of funds similar to the pooled loan certificates qualify for the Tax Law § 1453(e)(12) deduction. Specifically, bonds issued by the New York Power Authority and the Thruway Authority are repaid through third parties, not public funds; the bond holders expect payment to be made under the applicable flow of funds structure; and as long as the third parties make their payments to satisfy principal and interest obligations, the authorities need not use their own funds to ensure timely payment of the debt service. Further, neither of the authorities are legally obligated to make timely payments of principal and interest.[6]

In addition, petitioner argues that Farmers Home Administration ("FmHA") loan note guaranties, which qualify for the deduction in section 1453(e)(12), are supportive of its position because those obligations are in the nature of a legal guarantor and not a primary obligor; the holders of notes have a separate contractual relationship with the individual borrower; the FmHA

[6]These arguments were premised on documents never admitted into the record of this matter.

has no obligation to the holder of the note until the borrower defaults, the lender chooses not to repurchase the unpaid guaranteed portion of the loan and the holder makes written demand on the FmHA to repurchase; and there is no binding promise to pay specified sums at specified dates. Petitioner argues that these stark differences between the FmHA loan note guaranties and the pooled loan certificates support its position that the pooled certificates should qualify for the deduction.[7]

Petitioner also argues that the Administrative Law Judge's reliance on the words "guarantee" and "guaranty" in the certificates was misplaced since the use of these words do not control the actual nature of the SBA's legal obligation to certificate holders as characterized by petitioner. Petitioner relies on ***Fehr Bros. v. Scheinman*** (121 AD2d 13, 509 NYS2d 304) for the proposition that there can only be a guaranty if it is collateral to a contractual relation between the creditor-obligee and the principal-obligor. Petitioner argues that since there is no such relationship here, the SBA cannot be a guarantor.

Petitioner contends that the flow of funds does not make any difference to the SBA's true role in their relationship to certificate holders, that is, even though they expect the certificates to be repaid by the payments received from lenders, the SBA remains the primary obligor.

Petitioner claims that the Administrative Law Judge's denial of the deduction for these "federal obligations" was an unconstitutional discrimination against an obligation of the federal government in favor of those issued by New York.

Petitioner takes issue with the Administrative Law Judge's reliance on the language in the certificates which states that the owners acquire an undivided ownership interest in the loans and

[7]This argument also is premised on documents never admitted into the record in this matter.

therefore do not constitute a primary obligation of the SBA. Petitioner argues that Revenue Ruling 97-3 supports its conclusion because therein the IRS determined that the SBA was a primary obligor on payment rights represented by trust certificates guaranteed by the SBA. Petitioner believes that the certificates represent primary debt obligations of the SBA and not an undivided interest in the pooled loans. For federal tax purposes, petitioner contends that the SBA, not the certificate holders, are treated as the owner of the loans.

As noted in our footnote to finding of fact "7," petitioner disagrees with the Administrative Law Judge's interpretation of 15 USC § 634(g)(5)(A) concerning statutory subrogation rights. Petitioner believes that this section does not change the SBA's status as a primary obligor of the pooled loan certificates.

Petitioner argues that the certificates satisfy the intergovernmental immunity exemption from state taxation, noting that they meet the four requirements set forth in ***Rockford Life Ins. Co. v. Illinois Dept. of Revenue*** (***supra***).

Finally, petitioner argues that the Administrative Law Judge was mistaken in construing the word "deduction" in Tax Law § 1453(e)(12) as a deduction and not an exclusion, noting that the latter must be most favorably construed in favor of the taxpayer.

The Division contends that the Administrative Law Judge's determination was correct and argues that the pooled loan certificates do not meet the criteria set forth in the ***Rockford*** case, are therefore not federal obligations and cannot qualify for intergovernmental immunity.

The Division argues that the government's role vis-a-vis the certificates is that of a guarantor and that the expenditure of government funds is not a fixed and certain obligation, but a secondary and contingent one. The Division notes that 15 USC § 634(g)(2) plainly states that

the SBA guaranties to registered holders of the certificates the timely payment of principal and interest and that the certificates themselves couch the SBA's duty to certificate holders as a guarantor. In addition, the Division notes that the flow of funds supports the proposition that the SBA is acting as a guarantor, not primary obligor. Specifically, the Division notes that the certificate holders, not the SBA, benefit from any prepayment or early recoveries, indicating that Congress intended the SBA to be a clearinghouse for payments and a guarantor, as opposed to a primary obligor.

The Division believes that the intergovernmental tax immunity doctrine does not apply to the guaranteed loan pool certificates because they do not meet the ***Rockford*** criteria for federal obligations. In addition, the certificates are not used to raise money for the federal government or finance any governmental function but to attract major institutional investors to a secondary market which would open up new sources of capital for small business without any additional cost to the government. This congressional intent belies the existence of any fixed and certain obligation by the United States with respect to the pooled loan certificates.

The Division contends that petitioner's characterization of the SBA as a primary obligor was without merit and discounts testimony adduced at hearing and in an affidavit as conclusory statements on quintessential questions of law. In addition, the Division argues that Revenue Ruling 97-3 relied upon by petitioner was distinguishable because the participating security program at issue therein was completely different from the SBA certificates herein and lends little to the argument that the SBA was the primary obligor. Under the participating security program, the SBA had to make payments even if the Small Business Investment Companies ("SBICs") were not in default, as opposed to the instant situation where the SBA only makes

payment on the default of either the borrower or lender on the underlying loan. In addition, the Division points out that under the participating securities program, the SBA had continuing control over the loans in the trust while it retained no such control with respect to the pooled loan certificates.

The Division argues that petitioner's introduction of Thruway and Power Authority Bonds as well as FmHA documents was improper. The Division notes that the documents were rejected by the Administrative Law Judge since they were submitted after the record was closed in this matter.

Further, even if admitted, the Division believed the cited obligations are intrinsically different from the pool certificates. The FmHA documents would not qualify for the deduction for the same reasons the pool certificates do not qualify, denying that the loan note guaranty was the one considered by the Division in granting the deduction in TSB-M-86(7.1)C. The Division defends the deductions allowed for Thruway and Power Authority Bonds because they represent direct and primary obligations of the issuers, not just guaranties of a third party's debt obligation.

OPINION

Initially, we shall deal with the exhibits submitted by petitioner with its brief on exception. These documents refer to the New York State Thruway bonds, the New York State Power Authority bonds, and documents relating to the loan note guaranties of the FmHA. We note that these documents were first submitted to the Administrative Law Judge with petitioner's reply brief below. By letter, dated March 5, 1998, the Administrative Law Judge rejected the submission based on our decision in ***Matter of Schoonover*** (Tax Appeals Tribunal, August 15, 1991). In addition, the Administrative Law Judge refused to consider any arguments specifically

based upon this documentation. As stated above, petitioner has resubmitted these documents with its brief on exception, and urges us to accept them under our de novo review function.

On exception, the Tribunal may affirm, reverse or modify the Administrative Law Judge's determination, and otherwise make any decision the Administrative Law Judge might have made (***see***, Tax Law § 2006[7]; 20 NYCRR 3000.11[e]). Petitioner had the opportunity to introduce at the hearing all matters it thought necessary for the Administrative Law Judge to decide the case, and this established the official record for review by the Tribunal. At the end of the hearing, both parties acknowledged on the record that they had nothing further by way of evidence to submit and the record was closed. The Administrative Law Judge made the correct ruling on the documentation submitted with the reply brief below and the arguments in the reply brief based upon same.

Petitioner could have made a motion to reopen the record within 30 days of the determination, but failed to do so (20 NYCRR 3000.16). To the extent petitioner is attempting to submit evidence with its brief on exception, we reject it for the same reasons stated by the Administrative Law Judge and the rationale we set forth in our decision in ***Matter of Schoonover*** (***supra***). Although alluded to in the Division's brief, we also decline to take official notice of the documents attached to the brief. The State Administrative Procedure Act ("SAPA") provides that official notice may be taken of all facts of which judicial notice could be taken and of other facts within the specialized knowledge of the agency (SAPA § 306[4]). Judicial notice is defined as "the knowledge which a judge will officially take of a fact, although no evidence to prove that fact has been introduced" (Richardson, Evidence § 8 [Prince 10th ed]). Judicial notice may be taken of all facts which are common knowledge (e.g., the location of the Empire State

Building) (Richardson, Evidence § 9, ***supra***). The contents of a particular bond, instrument or other financial offering are not common knowledge and not a fact of which official notice may be taken.

On the issue of whether the interest income on SBA guaranteed loan pool certificates qualify for the deduction set forth in Tax Law § 1453(e)(12), we affirm the determination of the Administrative Law Judge.

Tax Law § 1453(e)(12) provides as follows:

> (e) There shall be allowed as a deduction in determining entire net income, to the extent not deductible in determining federal taxable income:
>
> * * *
>
> (12) twenty-two and one-half percent of interest income on obligations of New York state, or of any political subdivision thereof, or of the United States, other than obligations held for resale in connection with regular trading activities.

20 NYCRR 18-2.4(b)(12) provides, in part, as follows:

> The term *obligation* refers to obligations incurred in the exercise of the borrowing power of New York State or any of its political subdivisions or of the United States. This term does not refer to a guarantee of the debt of a third party. The following are examples of instruments that are not obligations incurred in the exercise of the borrowing power of New York State or any of its political subdivisions or of the United States:
>
> (i) guaranteed student loans;
>
> (ii) industrial development bonds issued pursuant to article 18-A of the New York State General Municipal Law;
>
> (iii) Federal National Mortgage Association mortgage-backed securities; and

> (iv) Government National Mortgage Association mortgage-backed securities.

31 USC § 3124 provides as follows:

> Exemption from taxation
>
> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except—
>
> (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and
>
> (2) an estate or inheritance tax.

The Administrative Law Judge identified the seminal issue: whether the guaranteed loan pool certificates are obligations of the United States of America or simply obligations guaranteed by the United States of America.

First, we must briefly address petitioner's claim that the deduction provided in Tax Law § 1453(e)(12) is not a deduction but an exemption. "[W]ords and phrases used in a statute should be given the meaning intended by the lawmakers" (Statutes, § 230). The word "deduction" is one with special and technical meaning within the Tax Law and must be so construed in the absence of anything to indicate a contrary legislative intent (Statutes, § 233). Petitioner has offered no persuasive authority for its claim that the statute created an exemption. Thus, petitioner bears the burden of establishing its right to the deduction provided for in Tax Law § 1453(e)(12) (***Matter of Grace v. New York State Tax Commn.***, ***supra***).

Additionally, petitioner contends that the Administrative Law Judge should have accorded more weight to the testimonial evidence and affidavit submitted in support of its position. After reviewing the entire record in this matter, we believe the Administrative Law Judge properly considered all of the evidence, including the testimony and the affidavit of SBA officials, as noted in the findings of fact. However, neither the Administrative Law Judge nor this Tribunal are bound by legal conclusions of witnesses or affiants.

Each party argues that the ***Rockford*** case supports its position on the issue of whether the pooled certificates should be eligible for the deduction. In ***Rockford***, the Supreme Court of the United States held that Ginnie Maes, instruments issued by private financial institutions possessing a pool of federally guaranteed mortgages, were not exempt from state taxation as United States obligations entitled to immunity from state taxation under either the statutory predecessor to 31 USC § 3124 or the doctrine of intergovernmental tax immunity. Of particular interest to our deliberation, is the fact that the Ginnie Mae pool of guaranteed mortgages, like the guaranteed portion of loans in the instant matter, provided the intended source of funds and the primary security for the principal and interest payments owed to the holders of the Ginnie Mae certificates. Like the pool certificates in issue, payment under the Ginnie Mae certificates was guaranteed by the Government National Mortgage Association and was backed by the full faith and credit of the United States.

The Supreme Court's rationale in ***Rockford*** for finding that the Ginnie Mae certificates did not qualify for the statutory exemption for obligations of the United States was that they were not direct and certain obligations of the United States. The Court found that the government's obligation was secondary and contingent to the primary payment obligation of the issuer of the

certificates, since the United States was the guarantor and not the obligor and did not bear the primary obligation to make timely payments.

The Supreme Court in ***Rockford*** also held that state taxation of Ginnie Maes did not violate the doctrine of intergovernmental tax immunity because that doctrine is based on the proposition that the borrowing power of the federal government may not be impaired or adversely affected by state taxing schemes. The Court cited four factors which it considered characteristic of obligations of the United States and, therefore, exempt from state taxation. As mentioned above, the obligations are characterized by 1) written documents, 2) the bearing of interest, 3) a binding promise by the United States to pay specified sums at specified dates, and 4) specific Congressional authorization which also pledges the full faith and credit of the United States in support of the promise to pay. Factors "1," "2" and "4" are clearly present in the instant matter, but a binding promise by the United States to repay specified sums at specified dates, which the Court said was the same as a direct and certain primary obligation, is missing.

Although the facts in ***Rockford*** are substantially similar but not identical, we believe the Court's rationale is controlling. The most significant similarity between the SBA certificates and the Ginnie Maes is that the expenditure of government funds is not a fixed and certain obligation, but a secondary and contingent one.

Although petitioner argues that it is not merely a guarantor, the record belies such an assertion. The governing statute, 15 USC § 634(g), speaks directly to the SBA's role as a guarantor. It specifically authorizes the Administration to issue certificates representing all or a fractional part of the guaranteed portion of one or more loans (15 USC § 634[g][1]); it provides that the Administration has the authority to guaranty the timely payment of the principal and

interest on the certificates (15 USC § 634[g][2]); and, it provides that the full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any guaranty of such certificates issued by the Administration. Much the same language is restated on the loan pool certificates themselves, leaving no doubt that the intent of Congress was to accord the SBA the role of guarantor and back the agency's guaranty with the full faith and credit of the United States.[8]

As noted by the Administrative Law Judge, the obligation of fulfilling the payment requirements on each loan in the pool remained with the individual borrower, not the SBA, and any prepayment or early recovery was passed directly to the certificate holder on a proportionate basis, conferring no benefit to the SBA. If there had been any intent by Congress to make the SBA the primary obligor, then it would not have deliberately provided for prepayments to benefit the certificate holders and not the SBA. However, this provision is consistent with the SBA's role as guarantor (15 USC § 634[g][2]; 13 CFR 120.707[b]).

In addition, 15 USC § 634(g)(5)(A) provides that if the SBA pays a claim under the provisions of the guaranty, the SBA becomes subrogated fully to the rights satisfied by such payment. This provision relates to the guaranty made by the SBA on the pool certificates as specifically stated in 15 USC § 634(g)(2) and is consistent with our conclusion that the SBA is a guarantor and not a primary obligor.

As the Administrative Law Judge noted:

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[8]We note that the United States Supreme Court in ***Rockford*** relied on language on the certificates in that case as supportive of the proposition that the United States' obligation was secondary and contingent ***(Rockford Life Ins. Co. v. Illinois Dept. of Revenue, supra*)**.

> These SBA guarantees make an investment in a loan pool "fail-safe" to the Certificate-holding investor, in that both the regularity of payments under the Certificate and, ultimately, payment of the full amount due under the Certificate is assured. Such assurances, undoubtedly, increase the appeal of the Certificates to investors. However, this does not change the SBA's role from that of one who has guaranteed the payment obligations under the Certificates, to the role of a primary obligor (Determination, conclusion of law "J").

The fact that the investment by a certificate holder is fail-safe, does not change the nature of the SBA's role from guarantor to primary obligor. Only in the case of a borrower's default or some breach by a lender will the SBA be obligated to make payment from its own funds in satisfaction of the guaranty. It may be true that the SBA uses the reserve fund on a regular basis to meet a small part of monthly obligations, but those funds originate from the borrowers and lenders and investments of those funds. The SBA guarantees timely payment to certificate holders " whether or not collected" under all circumstances, which indicates that the underlying guaranteed loans between private lenders and borrowers is the primary source of funds passing through to investors, while the role of the SBA is that of guarantor.

It is of no moment that the certificate holders do not know the identity of the individual borrowers whose payments fund the income from their certificates. The investors also are unaware of the lenders who received their consideration used to purchase guaranteed portions of loans which, in turn, made additional capital available to small businesses. There was no loan to the government or debt created on behalf of the SBA. According to the Secondary Market Program Guide, the investors purchased a portion of a pool of private debt assembled by a private institution (pool assembler), evidenced by a certificate issued by the SBA at the request of

the assembler, carrying a guarantee of payment by the SBA and backed by the full faith and credit of the United States.

We agree with petitioner that a guaranty is a separate, independent contract between the guarantor and the creditor-obligee and is collateral to the contractual obligation between the creditor-obligee and the principal-obligor (***Fehr Bros. v. Scheinman***, ***supra***, 509 NYS2d, at 305-306). However, based on our analysis, the principal-obligor is the borrower and the creditor-obligee is the lender. When certificate holders purchase an interest in the loan pool, they are placing themselves in the position of the creditor-obligees, receiving payments from the principal-obligors, the borrowers. The SBA's contract with its certificate holders is separate and independent from this relationship, and quite specifically guarantees the performance of the underlying contract.

This interpretation is consistent with the intention of Congress as cited in the Senate Report in support of the Small Business Secondary Market Improvements Act of 1984 (PL 98-352):

> [t]hrough the use of a secondary market, this bill is designed to open up new sources of capital for small business by permitting the pooling of the guaranteed portions of SBA loans for sale in larger lots to investors. In this way, such major institutional investors as pension funds, insurance companies, and mutual funds would be attracted for the first time to invest in Small Business Administration guaranteed loans, thereby allowing small business to tap capital pools previously unavailable. *This would be achieved at no additional cost to the Government* (Sen Rep No. 542, 98th Cong, 2nd Sess 1, reprinted in 1984 U.S. Code Cong & Admin News 550; emphasis added).

Since the SBA's status is as guarantor, any liability it may have under the guaranteed loan pool certificate program is contingent and uncertain and, in accordance with the requirement for

an instrument to be defined a federal obligation in ***Rockford***, it cannot be said to have met the third requirement that there be a binding promise by the United States to pay specified sums at specified dates.

Petitioner argues that Rev. Rul. 97-3 (1997-1 C.B. 9) supports its claim that the pool certificates should be deemed federal obligations. However, our review of the Revenue Ruling indicates that there is an important distinguishing factor, i.e., in the participating securities program, the SBA not only guarantees certain payments of redemption payments and prioritized payments to underwriters, it also retains the right to amend the participating securities evidenced by trust certificates. The SBA then uses this control over the underlying securities to substitute the redemption payments in regard to one participating security for another. The Revenue Ruling found the guaranteed payments made therein to be primary obligations of the SBA rather than secondary payments because of the differences in the obligations of the SBA and the SBIC's and the continuing interest of the SBA in the participating securities. Because of the structure of the Participating Securities Program, it was recognized that the SBA was going to have to make payments even when the SBICs were not in default. If an SBIC could not make a prioritized payment due to insufficient profits, the SBA would have to make the payments. In addition, the prioritized payments had to be made quarterly, and since the SBICs only made such payments annually, the SBA was committed to making those payments on a regular basis. Additionally, the Revenue Ruling pointed out that "the SBA will reasonably expect to disburse and not recover, during the pool's first three years, an amount exceeding 15 percent of the Prioritized Payments that would be due on the participating securities in the pool if Prioritized Payments had

to be made regardless of financial condition and were paid in quarterly installments rather than annually."

This is in stark contrast to the loan pool certificates where the SBA only makes a payment where the borrower or the lender defaults on the underlying loan. While the Revenue Ruling concluded, for federal tax purposes only, that the participating security program created a primary obligation on the part of the SBA, there is no basis to make that conclusion with respect to the loan pool certificates. Further, Revenue Ruling 97-3 does not support such a proposition.

Likewise, we reject petitioner's argument that the Division has exalted form over substance. The statutory authorization of 15 USC § 634(g) is clearly carried out in the regulations, the Secondary Market Guide and on the face of the certificates themselves. This is not merely form, it is the substance of the entire loan pool certificate program. As succinctly stated by the Administrative Law Judge:

> Stated simply, the investors own the pool of loans, and the Certificates are the evidence of such ownership. The SBA, as authorized, *guarantees* such owners' expectation of timely payment on the loans they own, thus protecting the investors against failures by one or more of the borrowers whose loans are in the pool (and against failures by the servicing lenders), and safeguarding or guaranteeing the payments, on time, which are due the owners of the pooled loans. The Certificates are not privately-issued certificates backed by a government guaranty, like the Ginnie Maes, but are government issued certificates evidencing ownership of a private pool of loans, which loans are government guaranteed as to principal and, additionally under the Certificates, as to timely periodic payment. The SBA does not guaranty to "make payments," but "guarantees the timely payment of [the amounts due under the Certificates]." The SBA does not sell the Certificates to the investors, or receive the proceeds therefrom. Rather, the SBA approves the pool and issues the Certificates evidencing each investor's proportionate ownership share or interest and specifying that the monthly payments owed each

investor in the pool are guaranteed. In sum, the United States is not incurring debt in the first instance, but is assuring the validity of a pool of *private* debt to the investors buying, holding and owning such debt. The SBA is the guarantor of the Certificates, and thus the Certificates are not primary obligations of the United States, as that phrase has been construed under either 31 USC § 3124 or ***Rockford v. Illinois*** (***supra***). Accordingly, petitioner is not entitled to deduct 22½ percent of the interest income earned on the Certificates pursuant to Tax Law § 1453(e)(12) (Determination, conclusion of law "P").

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of Sumitomo Trust and Banking Co. (USA) is denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of Sumitomo Trust and Banking Co. (USA) is denied; and

4. The Notice of Deficiency, dated July 22, 1996, is sustained.

DATED: Troy, New York
September 9, 1999

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner