STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
SUMITOMO TRUST AND BANKING CO. (USA)	:	DETERMINATION 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 a petition 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.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on June 10, 1997 at 9:00 A.M., with all briefs to be submitted by December 5, 1997, which date began the six-month period for the issuance of this determination. Petitioner appeared by Arthur Anderson, LLP (Michael H. Goldsmith, Esq. and Kenneth T. Zemsky, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Marvis A. Warren, Esq. and Kenneth T. Schultz, Esq., of counsel).

ISSUE

Whether, in determining petitioner's entire net income, the Division of Taxation improperly disallowed petitioner's deduction, pursuant to Tax Law § 1453(e)(12), of 22½

percent of the interest income generated by Small Business Administration guaranteed loan pool certificates owned by petitioner.

FINDINGS OF FACT[1]

1. 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.

2. 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.

3. 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

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[1] In addition to the evidence introduced at hearing petitioner submitted, with its reply brief, four exhibits in support of arguments made in its reply brief at points IV and V thereof. Upon objection by the Division of Taxation, and based upon the Tax Appeals Tribunal's rulings which prohibit the submission of evidence after the record of hearing has been closed, these exhibits were returned to petitioner and the arguments based thereon as raised in petitioner's reply brief have not been considered.

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.[2] 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.

4. 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[3], 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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> Assemblers who wish to hold the pool for their own investment portfolios will have certificates issued in their own names. Assemblers who have sold

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[2] 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.

[3] 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.

> 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.

5. 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.

6. 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.

7. 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.[4] 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

[4] 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 guarantee 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.

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.

8. 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.

9. 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).

10. 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.

11. 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.

12. 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.

13. 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 guarantee of the payment of the loans comprising the pool and, in terms of cash flow management for meeting expenses, because of the added guarantee of timely periodic payments on the payment date.

14. 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.

15. 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.

16. 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 a 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.

17. Mr. Cox explained that a default by a borrower causes the SBA, under its loan guarantee, 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.

18. With its brief, the Division submitted proposed findings of fact numbered "1" through "35". Such proposed facts are supported by evidence in the record and have been accepted and substantially incorporated into the Findings of Fact herein noting specifically, however, that:

> --proposed fact "5" is accurate insofar as it states that petitioner did not "attach a statement describing the instruments on its [Franchise Tax Return] for the year 1991." However, this proposed fact has been augmented to point out that petitioner was not required to attach a statement to its return describing the instruments in question.
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> --proposed facts "10" through "15" have been condensed, with the relevant information therefrom set forth in Finding of Fact "3".
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> --proposed facts "18" and "30" are revised to eliminate the emphasis on the word "may"; proposed fact "19" is revised to eliminate the emphasis on the phrase "guaranty appearing on the face of the certificate"; and proposed fact "27" is revised to eliminate the emphasis on the phrase "due and paid by the borrower".
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> --proposed fact "20" has been eliminated as irrelevant.
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> --proposed fact "29" is accepted as literally accurate, but the use of the words "guaranty" and "guarantees" therein is without prejudice to petitioner's arguments in this matter.

CONCLUSIONS OF LAW

A. 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,
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> * * *
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> (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. . . .

B. 20 NYCRR 18-2.4(b)(12) provides 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:
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> (i) guaranteed student loans,
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> (ii) industrial development bonds issued pursuant to Article 18-A of the New York State General Municipal Law,
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> (iii) Federal National Mortgage Association mortgage-backed securities, and
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> (iv) Government National Mortgage Association mortgage-backed securities.

C. 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—
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> (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and
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> (2) an estate or inheritance tax.

D. The critical phrase in this case is "obligations of the United States." Entitlement to the deduction at issue depends upon whether the Certificates in question are obligations of the United States, as opposed to obligations guaranteed by the United States. Petitioner argues that although termed a *guaranty*, the promise of timely payment of the amounts due each month under the Certificates renders such Certificates primary obligations of the United States which are thus eligible for the deduction provided under Tax Law § 1453(e)(12). Petitioner distinguishes the pool Certificates from the individual loan certificates, in that the latter type of certificates carry only a government guarantee of payment in the event of default by the loan

borrower, with no additional guaranty of timely monthly payment. Petitioner acknowledges, therefore, that the individual loan certificates would not qualify for the Tax Law § 1443(e)(12) deduction for failure to contain a government promise of payment of "specific amounts on specific dates."

E. The phrase "obligations of the United States," has been addressed in the context of exemption from state taxation at both the statutory level (31 USC § 3124) and, in interpretation thereof, by the United States Supreme Court in ***Matter of Rockford Life Insurance Company v. Illinois Dept. of Revenue*** (482 US 182, 96 L Ed 2d 152, 107 S Ct 2312)**.** Petitioner seeks to show that the Certificates represent direct and certain primary obligations of the United States government within the coverage of 31 USC § 3124, or that the Certificates meet each of the four criteria set forth in ***Rockford v. Illinois*** (***supra***) and thus qualify as obligations enjoying protection under the constitutional principle of intergovernmental tax immunity. In turn, if the Certificates so qualify, there is no dispute that petitioner is entitled to the 22½ percent interest deduction provided under Tax Law §1453(e)(12).

F. The parties differ as to the proper characterization of the statutory section at issue. Petitioner claims that Tax Law § 1453(e)(12) provides an "exclusion" from tax, which should be construed most favorably for petitioner. In contrast, the Division argues that petitioner is claiming a statutory "exemption," which should be construed most strongly against petitioner who must establish entitlement thereto. The statutory section in question, Tax Law § 1453(e)(12), specifically uses the term "deduction". A deduction is "functionally a particularized species of exemption from taxation" (***Matter of Grace v. New York State Tax Commn.,*** 37 NY2d 193, 371 NYS2d 715). In turn, it is well settled that exemptions from taxation are to be strictly and narrowly construed since "an exemption is not a matter of right, but is allowed only

as a matter of legislative grace," with the burden of establishing entitlement thereto resting upon the party seeking the same, i.e., petitioner (***Id., see Matter of Saratoga Harness Racing, Inc. v. State Tax Commn.,*** 119 AD2d 919, 501 NYS2d 200, ***lv denied*** 68 NY2d 610, 508 NYS2d 1027). Stated differently, interest income earned on United States government obligations is entirely includable in the banking franchise tax entire net income base. However, under Tax Law § 1453(e)(12), the Legislature has made available to taxpayers the specific benefit of a deduction equal to 22½ percent of such interest income. In order to take advantage of this legislatively allowed benefit, petitioner bears the burden of establishing that the otherwise fully includable interest income was generated by the type of investment (i.e., United States obligations) specified in the deduction statute. In short, the "burden is on the taxpayer seeking the deduction to establish his right to it" ***(Matter of Grace v. New York State Tax Commn, supra).***[5]

G. In ***Rockford v. Illinois*** (***supra***) the Supreme Court examined the issue of whether financial instruments known as Ginnie Maes qualified 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. The Court described the Ginnie Maes as instruments issued by private financial institutions possessing a pool of federally guaranteed mortgages. This pool of guaranteed mortgages, like the pool of guaranteed loan portions in this case, 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. Each Ginnie Mae

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[5] It should be made clear that there is no argument that either 31 USC § 3124, or the principle of intergovernmental tax immunity, serve to bar the interest on the Certificates from inclusion in the measure of the entire net income base subject to the Article 32 franchise tax on banking corporations. In this regard, even if the Certificates qualify as obligations of the United States exempt from state taxation, it is undisputed that the interest earned thereon, less the 22½ percent deduction amount specifically allowed under Tax Law § 1453(e)(12), may nonetheless be included in the base measure subject to a nondiscriminatory franchise tax (31 USC § 3124[a][1]). Thus, the determining factor in whether the 22½ percent deduction is available is simply whether the Certificates are obligations of the United States.

certificate also carried with it a provision whereunder the Government National Mortgage Association, a United States government corporation, guaranteed payment on the certificates if the issuing financial institution defaulted. This guarantee of payment was backed by a pledge of the full faith and credit of the United States.

The Court held that the Ginnnie Mae certificates were not exempt from state taxation. While dealing separately, in its opinion, with the statutory exemption provision and the intergovernmental tax immunity doctrine, the Court pointed out that the statutory provision was "principally a restatement of the constitutional rule" (***Rockford v. Illinois, supra,*** at 188). As for the statutory exemption for obligations of the United States, the Court concluded that the Ginnie Mae certificates were not direct and certain obligations of the United States, but rather that the government's obligation was secondary and contingent to the primary payment obligation of the issuer of the certificates. The Court held that since the United States was the guarantor and not the obligor, it simply did not bear the primary obligation to make timely payments. In short, the Ginnie Maes were not primary obligations of the government per the terms of the exemption statute.[6]

Turning to the issue of constitutional immunity, the Court explained that the doctrine of intergovernmental tax immunity "is based on the proposition that the borrowing power is an essential aspect of the Federal Government's authority and, just as the Supremacy Clause bars the States from directly taxing federal property, it also bars the States from taxing federal obligations in a manner which has an adverse effect on the United States' borrowing ability." (***Rockford v.***

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[6] The Court addressed the statutory exemption in terms of the predecessor statute to 31 USC § 3124, since section 3124 had not been enacted at the time the cause of action in ***Rockford*** accrued. However, the Court pointed out that the predecessor statute (31 USC § 742) was recodified in 1982 as 31 USC § 3124 without substantive change ***(see, Rockford v. Illinois, supra*** at 183, n. 1).

Illinois, supra, at 190.) The Court pointed to the four factors identified in ***Smith v. Davis*** (323 US 111, 89 L Ed 107, 65 S Ct 157) as characteristic of obligations of the United States which are exempt from state taxation. Specifically, such 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. In this case, the third factor is at the heart of the dispute. As the court recognized, the requirement of a binding promise by the United States "to pay specified sums at specified dates" is substantively the same as a direct and certain primary obligation, versus a secondary and contingent obligation, to pay. The court concluded, consistently, that the indirect, contingent and unliquidated guarantee of the payments due under the Ginnie Maes was not sufficient to invoke the protection against state taxation of federal obligations afforded under the constitution.

H. Petitioner claims entitlement to the deduction in question by arguing that the Certificates are obligations of the United States. Petitioner notes that the Certificates are issued by the SBA, and that there is no dispute that the SBA is an agency of the executive branch of the United States government. Petitioner admits that the Certificates use the term "guarantee" with regard to the timely payment aspect of the Certificates, but argues that such term in fact constitutes a promise to pay regardless of whether the underlying loan borrowers make their payments or whether the servicing lenders forward such payments to the FTA for remittance to the Certificate holders. Petitioner thus argues that despite using the word guarantee, the Certificates actually make a direct promise to pay, and therefore represent securities on which the SBA, an agency of the executive branch of the United States, is the primary obligor. Petitioner maintains that the Certificates are therefore obligations of the United States exempt from state

taxation as contemplated under both the statutory standard of 31 USC § 3124 and under the constitutional doctrine of intergovernmental tax immunity. Petitioner acknowledges that SBA individual loan certificates would not qualify for the 22½ percent deduction, in that there is only a guarantee of payment in the event of default by the borrower. However, petitioner argues that the additional "guarantee" of timely payment provided by the pool Certificates, regardless of whether or not the underlying loan borrowers or servicing lenders fulfill their obligations, is more than a guarantee and rises to the level of a direct and certain obligation of the United States. Petitioner argues, in essence, that the SBA has made a promise of timely payment and that to construe such promise as a guarantee would be to conclude that the SBA was simply, and superfluously, guaranteeing its own obligation.

I. 15 USC §634(g) provides, in pertinent part:

> (g) **Issuance of trust certificates for guaranteed portion of loan**. (1) The Administration is authorized to issue trust certificates *representing ownership of all or a fractional part of the guaranteed portion of one or more loans* which have been guaranteed by the Administration under this Act, . . ., *provided*, That such trust certificates shall be based on and backed by a trust or pool approved by the administration and composed solely of the entire guaranteed portion of such loan.
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> (2) The Administration is authorized, upon such terms and conditions as are deemed appropriate, to *guarantee the timely payment of the principal of and interest on trust certificates* issued by the Administration or its agent for purposes of this subsection. Such *guarantee* shall be limited to the extent of principal and interest on the guaranteed portions of loans which compose the trust or pool. In the event that a loan in such trust or pool is prepaid, either voluntarily or in the event of default, the guarantee of timely payment of principal and interest on the trust certificates shall be reduced in proportion to the amount of principal and interest such prepaid loan represents in the trust or pool.
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> (3) 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 guarantee of such trust certificates issued by the Administration or its agent pursuant to this subsection.

* * *

> (5)(A) In the event the Administration pays a claim under a *guarantee* issued under this subsection, it shall be subrogated fully to the rights satisfied by such payment. (Emphasis added.)

J. Turning to the matter at hand, each certificate-holding investor owns an undivided interest in a pool of loans, with such ownership evidenced by a trust Certificate. The obligation of fulfilling the payment requirements of each loan in the pool remains with each individual borrower. In turn, each lender, although having been repaid on its loan, continues to service the loan, and has the obligation to timely forward each borrower's loan payment to the FTA. The FTA receives such payments, as well as any prepayments or early recoveries, for all of the loans in the pool, accounts for the same, and remits the payments owed to the Certificate-holding owners of the pool of loans in accordance with the terms of the Certificates. The SBA's role in this program is to serve as the guarantor that each of such obligations will be fulfilled, i.e., that the amount of any loan in the pool, if defaulted, will nonetheless be paid under the SBA's loan guarantee, and that the monthly payment amounts due under the Certificates will be made on schedule even if the underlying borrower payments are not made due to deferral or default, or are not forwarded on time or at all (for whatever reason) by the servicing lenders. 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. This conclusion is borne out by the words on the Certificate itself which specify the SBA's role as that of a guarantor, a role which alone is clearly insufficient to cause the Certificates to be considered obligations of the United States (***see, e.g., S.S. Silberblatt, Inc. v***

Tax Commn of New York, 5 NY2d 635, 186 NYS2d 646 ***cert denied***, 361 US 912, 4 L Ed 2d 183, 80 S Ct 253).

K. The fail-safe assurance of the Certificates, though absolute, remains only a contingent obligation of the SBA rather than a certainty. That is, if all borrowers meet all loan obligations in a timely manner, then the SBA will not be required to advance or pay out any monies. It is only when, and if, a borrower falls into arrearage, or a servicing lender fails in some aspect of its duties, that the guarantee is implicated and the SBA is required to use its funds to meet the obligation owed to the Certificate-holding owners of the pool. Given the contingent nature of the expenditure of SBA monies, it cannot be concluded that the Certificates are direct and certain obligations of the United States under which the expenditure of governmental monies will be required. As noted in the Division's Opinion of Counsel, the legislative history behind the SBA's secondary market program reflects that there was no intention to expend government funds on the pooling program. Specifically cited in this regard is the Senate Report in support of the Small Business Secondary Market Improvements Act of 1984 (PL 98-352) as follows:

> [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.)

L. Although the SBA's secondary market program serves the purpose of promoting the availability of capital for investment into small businesses, the fact remains that the government, through the SBA (and FTA), serves as a trustee/administrator and guarantor. This conclusion is entirely consistent with the language of the guaranty on the face of the Certificates and with the

manner in which the secondary market program is administered. For example, there is the fact that any borrower prepayments or early recoveries of principal are paid over to the investors as recovered rather than held by the SBA (***see,*** 13 CFR 120.706[b]; SBA Secondary Market Program Guide at p 17, § B, p 23, § G, p 24, § IV-2). Under this approach, and as specified in the fourth paragraph of the Certificate, the monthly payment amount could, as the result of any prepayments or early recoveries, be greater than the monthly amount due under the terms of the Certificate. However, in no event will such amount be less than the amount of principal and interest due monthly per the Certificate. In essence, the SBA guarantees that the monthly payment will always at least equal the minimum amount due per the terms of the Certificate, although in fact it could be greater. This speaks strongly in favor of the government's being a guarantor. That is, if the SBA's obligation is to make monthly payments per the Certificates without regard to underlying events (e.g., prepayments or other early recoveries), then it would not be obliged to turn over any prepayments or early recoveries to the Certificate holders, but instead would make only its obligatory monthly payments and retain and use the prepayments or early recoveries for its own investment or other (governmental) purposes. This feature of the Certificates, whereby the owners are entitled to all payments on the underlying loans as made, including prepayments and early recoveries, is consistent with the SBA's role as that of a guarantor assuring that, at a minimum, the monthly payments due under the Certificates will be made regardless of underlying failures.

M. The words of the Certificate itself are telling, in that the SBA specifically "guarantees the timely payment of" the amounts due the investors, rather than stating the more direct "guarantees to pay" or "promises to pay". In fact, if the SBA's obligation is a primary obligation

of payment on time, then the words "whether or not collected", appearing in the terms on the face of the Certificates, would be nothing more than superfluous verbiage.

The SBA does not make the underlying loans in the first instance. More importantly, it does not receive for its own uses and purposes monies paid by the Certificate-holding investors upon the purchase of interests in the pools. Furthermore, the SBA faces no certain requirement to use its own funds to meet obligations to investors unless and until the individual borrowers (or servicing lenders) fail to meet their obligations. According to the SBA's regulations in this regard, each pool is expected to be "self-liquidating" (13 CFR § 120.709[b]), and "[i]n the case of nonpayment by the borrower on a loan in a pool backing the certificates, SBA through its FTA shall make *advances* to maintain the schedule of interest and principal payments to the registered holders until SBA purchases the guaranteed portion" (***see*** 13 CFR 120-.706[b]; emphasis added).[7] Throughout the law and regulations, the phraseology specifies that the *guaranty* of the Certificates is backed by the full faith and credit of the United States (***see*** 15 USC § 634[g][3]; 13 CFR 120.701; ***see also*** SBA Secondary Market Guide at p 14, § III-4). It is clear, and there is no dispute between the parties, that a guaranty is not the same as a primary obligation. Here, there is no certainty that any payments will be required by the United States on any set date or dates. At best, the SBA's position with respect to the Certificates should be described as an obligation which may, and in all likelihood will, arise and have to be met when, if and as failures occur by the primary obligors under the loans included in the pool.

N. It is true that the Certificate-holding investors may not know the individual borrowers or servicing lenders, and this fact would support an argument that the investors hold simply an

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[7] 13 CFR Chapter I, Subpart G--Pooling of SBA Guaranteed Portion, provides, at section 120.701, in part, that "[t]ransactions involving the sale of interests in pools are governed by the specific terms and provisions of these regulations, SBA's Secondary Market Guide and contracts entered into by the parties".

SBA (i.e., government) obligation to pay each month. However, this must be balanced against the fact that the investors are not loaning money to the government, but rather are buying a portion of a pool of private debt owed by various private borrowers, evidenced by an SBA issued Certificate of ownership carrying with it an SBA guarantee of payment of what the owning investors are owed.

O. As in ***Rockford v. Illinois*** (***supra***), the fact remains that unless a borrower fails to pay, or a lender fails to forward, "no federal funds are used in connection with the issuance and sale of these securities, the administration of the pool, or the payments of principal and interest set forth in the certificates" (***Rockford v, Illinois, supra*** at 187). The SBA incurs no debt upon issuance of a Certificate. Rather, the SBA, through the FTA, serves as 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 when the borrowers do not pay or the lenders do not forward. This role is consistent with the secondary market program, the SBA's role therein, and with the terms of the Certificate which specifically cast the SBA's obligation as a guarantee of what the owners (investors) are entitled to--timely monthly payments of principal and interest. (***See generally,*** 13 CFR 120.701, 120.706[b];120.711.) It is clear that the SBA *may* be required to step in and use its own funds to make good the obligations of others, and that *if* the SBA is required to step in and make such payments, the full faith and credit of the United States is pledged in fulfillment of such obligation. However, such occurrence remains a contingency and not a direct, certain, continuous and ongoing *primary* obligation. It is entirely consistent with this conclusion that

the SBA retains the investors' first principal payments in order to "grow" a reserve fund to be available to the FTA to honor the timely payment guaranty.

Similarly, where the SBA pays a claim under a guarantee, including its guarantee of timely payment, "it shall be fully subrogated to the rights satisfied by such payment" (***see,*** 15 USC § 634[g][5][A]; 13 CFR 120.709[c]). Petitioner argues that this provision should be read to apply only to the situation where the SBA pays under its guarantee in the event of a defaulted loan. However, 15 USC § 634(g), which provides specific authorization for the SBA to "guarantee the timely payment of principal and interest on trust certificates," including specifically pool trust certificates, does not so limit the subrogation provision of 15 USC § 634(g)(5)(A). The fact that the SBA becomes fully subrogated to the rights satisfied by *any* payments it makes pursuant to a guarantee, including the right to timely payments due the pooled loan Certificate-holding investors, is entirely consistent with and supports the conclusion that the SBA is a guarantor rather than a primary obligor.

P. The statutory authorization of 15 USC § 634(g) is carried out in the SBA's regulations, its Secondary Market Guide, and in the terms on the face of the pooled loan Certificates. 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 guarantee, 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 guarantee 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).

Q. The petition of Sumitomo Trust and Banking co. (USA) is hereby denied and the Notice of Deficiency dated July 22, 1996 is sustained.

DATED: Troy, New York
June 4, 1998

/s/ *Dennis M. Galliher*
ADMINISTRATIVE LAW JUDGE