

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
JOHN LA MONTAINE) No. **84R-1113-SW**

For Appellant: John La Montaine,
in pro. per.

For Respondent: A. Jovanovich
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a), ¹ of the Revenue and Taxation Code from the action of the Franchise Tax Hoard in denying the claim of John La Montaine for refund of personal income tax in the amount of \$471 for the year 1981.

1/ Unless otherwise specified, all section references are to sections of the Revenue' and Taxation Code as in effect for the year in issue.

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The sole issue in this appeal is whether appellant is entitled to a refund of taxes paid on interest income from securities guaranteed by the Government National Mortgage Association.

When appellant filed his state tax return for 1981, he included on his return interest from securities guaranteed by the Government National Mortgage Association (GNMA).^{2/} These amounts were included in appellant's gross income and were taxed accordingly.

On March 26, 1984, appellant filed an amended return for the year 1981, in which he stated that the interest income from the Ginnie Maes was erroneously included in his gross income. In support of his position appellant asserts that during 1981, interest from Ginnie Maes was not taxed in California and that to tax these securities would constitute unequal application of the law.

Respondent treated appellant's amended return as a claim for refund and denied the claim on June 26, 1984. **Respondent's position** is that the Ginnie Maes are not obligations of the United States Government; therefore, interest from such securities is subject to California personal income taxation. This position was documented in a letter to various state and national publishers from Glenn L. Rigby, Chief Counsel of the Franchise Tax Board on May 14, 1984, which stated, in part that:

Interest income from securities commonly known as G.N.M.A. "Pass-Through" or "Mortgage-Backed" securities ("**Ginnie Maes**"), issued by approved entities and guaranteed by the Government National [Mortgage] Association under 12 U.S.C.A. Section 1721(g) is taxable for purposes of California personal income taxation. These certificates are not direct obligations of the United States Government. Therefore, despite the backing of the full faith and credit of the

^{2/} It is assumed that the securities referred to in the appeal are Ginnie Maes issued under 12 U.S.C. § 1721(g) (1976). Although neither respondent nor appellant have specifically identified the certificates, the letter referred to by appellant, and the cases referred to by respondent, all involve Ginnie Maes, which are, in fact, backed by GNMA.

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United States, they are a remote and contingent liability of the federal government and, as such, are subject to state taxation. (Montgomery Ward Life Ins. Co. v. State Department of Local Government, (1980) 89 Ill. App. 3d 292, 411 N.E.2d 973; accord: Farmers and Traders State Bank v. Johnson, (1984) 121 Ill. App. 3d 43.[]] **This ruling** represents a change from our previous position, and **is** applicable to all open taxable years.

Section 17137 provides that gross income will not include any income which California is prohibited from taxing because of the laws of the United States. Congress, in passing 31 U.S.C. section 3124(a), provided that stocks and obligations of the United States Government are exempt from taxation by any state. The issue in this appeal, therefore, is whether the Ginnie Maes are obligations of the United States Government.

As early as 1944, the United States Supreme Court in the case of Smith v. Davis, 323 U.S. 111 [89 L.Ed. 107], set out the four requirements which must be met: before a security can be classified as an obligation of the United States. Basically, the certificates must be written documents which bear interest and have a binding promise by the United States to pay specified sums at specified dates. Finally, there must be a pledged-full faith and credit by the United States to support the promise to pay. Respondent has concluded that the certificates guaranteed by GNMA satisfy all the requirements except the one which requires a binding promise by the United States to pay specified sums at specified dates.

The question of whether Ginnie Mae certificates, guaranteed by GNMA and backed by the full faith and credit of the United States, are themselves subject to state taxation was resolved against the taxpayer in Montgomery Ward Life Insurance Co. v. Department of Local Government Affairs, 411 N.E.2d 973 [89 Ill.App.3d 292] (1980). In this case, the court described the history of GNMA:

In 1968, Congress, in an effort to attract private capital into the secondary mortgage market of private housing, created GNMA as a wholly-owned government corporation (see 12 U.S.C. § 1716b (1976)) and authorized it to implement what has become known as the Mortgage Backed Securities Program. (12 U.S.C.

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§ 1721(g) (1976).) A "secondary market" is, in general, the means whereby initial mortgage lenders, such as banks and savings and loan associations, can refinance mortgages that have already been written, thereby freeing their capital to make more mortgage loans. Specifically, GNMA and its counterpart, the Federal National Mortgage Association (FNMA) are to assist this secondary market "by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing." (12 U.S.C. § 1716(a) (1976).) New types of securities were authorized: Fannie Maes issued by FNMA under 12 U.S.C. § 1719(d) (1976), Mortgage Participation Certificates issued by GNMA under 12 U.S.C. § 1717(c) (1976), and Ginnie Maes issued by GNMA under 12 U.S.C. § 1721(g) (1976). The instant appeal involves the later type of certificates.

(411 N.E.2d at 974.)

The court went on to describe the basic operation of the program as follows:

A financial institution or mortgage servicing **company wishing to participate must assemble or** acquire a pool of government insured or guaranteed mortgages. GNMA then enters into a standard form "Guaranty Agreement" with the issuer, under which, inter alia, GNMA agrees to guarantee timely **payments of** principal and interest as required by the terms of the securities [citation], and the issuer agrees to remit in a timely manner all payments required by the terms of the securities. [Citation,] Should the issuer fail to make timely payments as required, the security holder's sole recourse is against GNMA. [Citation.] Eoweer, GNMA may treat the issuer's failure to make required payments as an event of default under the Guaranty Agreement [citation], and this provides GNMA with the option of extinguishing the issuer's interest in the pooled mortgages and becoming owner of those mortgages "subject only to the unsatisfied rights of **the holders of the securities**"

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. . . . The statute authorizing the program **provides** for the issuance of securities "based on and backed by" specified guaranteed mortgages in a "trust or pool." 12 U.S.C. § 1721(g). The issuer, at the time the pool is created, assigns all its rights in the underlying mortgages (including its rights to all interest, principal, and other payments made on or with respect to such mortgages) to GNMA "[t]o provide a base and to back all securities issued". [Citation.] The authority of the issuer; to "file, process and receive the proceeds from ... guaranty claims" is specifically made subject to this assignment. [Citation.] A "custodial account" is established, **into which** the issuer deposits proceeds from the pooled mortgages and from which withdrawals may generally be made only for payments to security holders. . . . Segregation of the cash flow from mortgages in the pool from the other assets of an issuer is strictly required. [Citation.] The issuer is paid a fee for its services in administering the pool based on and payable from the interest portion of each monthly installment. [Citation.] The Guaranty Agreement insures that the **issuer** retains only bare legal title sufficient to enable it to service the mortgages.

(411 N.E.2d at 975.)

In holding that the certificates did not constitute a binding promise to pay a specified sum at a specified time, the Montgomery Ward court stated that the bank, which issued the Ginnie Mae certificates, is primarily liable to make the monthly interest payments and to ultimately repay the principal. The certificates would not become the immediate obligation of GNMA until this issuer defaulted and once that happened, the pool of mortgages would become the property of GNMA. The court concluded, therefore, that payment by GNMA is contingent and wholly speculative. The Ginnie Mae certificates themselves were held not to be subject to state taxation.

The issue of whether the interest earned on Ginnie Maes was immune from taxation was addressed by the court in Farmers & Traders State Bank v. Johnson, 458 N.E.2d 1365 [121 Ill.App.3d 43] (1984). Like the Montgomery Ward court, the Farmers court found that the interest earned on Ginnie Maes is not exempt from state

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taxation because the certificates do not carry a binding promise by the United States to pay specified sums at specified times: and the certificates are not used to secure credit for the government, but to attract private capital so that government credit would **not be** necessary.

Appellant contends that respondent is estopped from considering the interest from the Ginnie Maes to be taxable because the letter' from Chief Counsel Glenn **Rigby** was not issued until 1984. The period in issue in this appeal is 1980. Once again, we cannot agree. The purpose of Mr. **Rigby's** letter in 1984 was to correct a mistaken interpretation of the law regarding the taxability of interest income from Ginnie Maes. We have previously held in the Appeal of Wilhelm S. and Geneva B. Everett, decided November **13, 1973**, that the doctrine of equitable estoppel is not a bar to the exercise of the power to make rulings or regulations retroactive since that doctrine does not prevent the correction of a mistake of law. (See Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 183 [**1 L.Ed.2d 7461 (1957)**].)

In sum, we conclude that the interest on the Ginnie Maes was properly found to be subject to **state** tax and that respondent was not estopped from correcting a mistaken interpretation of the law. Accordingly, the action of respondent must be sustained.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor, -

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of John La Montaine for refund of personal income tax in the amount of \$471 for the year 1981, be and the same is hereby sustained.

Done at Sacramento, California, this 4th **day** Of February , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. **Collis**, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman
Conway H. Collis , Member
William M. Bennett , Member
Ernest J. Dronenburg, Jr. , Member
Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9