SC REVENUE RULING #91-15

SUBJECT: Interest Exempt from South Carolina Income Tax

TAX ANALYST: Jean P. Croft

EFFECTIVE DATE: All periods open under statute

SUPERSEDES: S.C. Information Letter #88-7 and any oral directives in conflict herewith.

31 USC §3124(a)

AUTHORITY: S.C. Code Section 12-4-320 (Enacted June, 1991)
SC Revenue Procedure #87-3

SCOPE: A Revenue Ruling is the Commission's official interpretation of how tax law is to be applied to a specific set of facts. A Revenue Ruling is public information and remains a permanent document until superseded by a Regulation or is rescinded by a subsequent Revenue Ruling.

Question:
What guidelines can the Commission provide as to the taxability of interest from certain obligations for purposes of Chapters 7 and 13 of Title 12 of the South Carolina Code?

Facts:
Recent court decisions and legislation have raised questions concerning whether interest received from particular obligations is taxable. This document will clarify these issues and provide guidelines for determining if interest is exempt from South Carolina income taxation.

Discussion:
IRC §61(a) provides that interest is taxable to whomever receives it; however, interest received from certain obligations is exempt from South Carolina income taxation. The discussion of the types of interest which are exempt from South Carolina income taxation can be divided into three categories: state and local obligations, obligations congressionally designated as nontaxable, and obligations of the United States.
STATE AND LOCAL OBLIGATIONS

Internal Revenue Code (IRC) Section 103(a) provides that gross income does not include interest on any state or local bond. IRC §103(c) defines "state or local bond" as "an obligation of a state or political subdivision thereof". Section 103 further provides that the interest from private activity bonds is not exempt unless the bonds are "qualified bonds" within the meaning of Section 141 of the Internal Revenue Code. South Carolina Code §12-7-430(b) states that South Carolina gross income is computed as provided in the Internal Revenue Code with certain modifications:

(1) The exclusion from gross income authorized by Internal Revenue Code Section 103 is modified to exempt only interest upon obligations of this State, any of its political subdivisions, and to exempt interest upon obligations of the United States.

Therefore, interest from a state or local bond is excluded from South Carolina gross income only if it is an obligation of South Carolina or any of its political subdivisions which is exempt from federal income taxes pursuant to Section 103 of the Internal Revenue Code of 1986. Hence, interest from private activity bonds issued by South Carolina or any of its political subdivisions are excluded from South Carolina gross income only if they are qualified bonds within the meaning of Section 141 of the Internal Revenue Code.

OBLIGATIONS CONGRESSIONALLY DESIGNATED AS NONTAXABLE

Certain federal agencies and/or instrumentalities are empowered to issue obligations to provide funding for their stated purposes. Many of these contain language in their enabling legislation prohibiting the levying of a state or local tax. For example, 12 USC §2134 states:

Each bank for cooperatives and its obligations are instrumentalities of the United States and as such any and all notes, debentures, and other obligations issued by such bank shall be exempt, both as to principal and interest from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States or any State, territorial, or local taxing authority, except that interest on such obligations shall be subject to Federal income taxation in the hands of the holder.

Therefore, a state is prohibited from taxing interest on obligations issued by a bank for cooperatives. Similar language is used in other federal statutes. When a federal statute provides that certain interest is exempt from state taxation, such interest is excluded from South Carolina gross income.

OBLIGATIONS OF THE UNITED STATES

Section 3124(a) of Chapter 31 of the United States Code requires that:

(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.

Note: The predecessor statute to 31 USC §3124 was 31 USC §742 (also referred to as Revised Statutes §3701) which was recodified in 1982 with no substantive changes. (See Pub. L. 97-258, §4(a), 96 Stat. 1067.) This document will use the current reference of the statute in all of the cites to this section.

As mentioned above, SC Code §12-7-430(b)(1) exempts from South Carolina income taxation interest earned upon obligations of the United States; however, the question arises as to what securities constitute "obligations of the United States".

In Smith v. Davis, 323 US 111, 65 S.Ct 157 (1944), the Supreme Court set forth four qualities which characterize obligations "which this Court in the past has recognized as constitutionally exempt from state and local taxation":

(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 pledged the faith and credit of the United States in support of the promise to pay.

Furthermore, the Court stated that, under the rule of ejusdem generis, the term "obligations" used in [31 USC §3124] "refer[s] to obligations or securities of the same type as those specifically enumerated". Therefore, if an obligation is not similar to stocks, bonds, and Treasury notes and does not meet the four qualifications listed above, it should not be considered an obligation of the United States.

Federal Tax Refunds

The criteria set forth in Smith v. Davis, supra, can be applied to the interest paid by the federal government on federal tax refunds. IRC §6611(a) provides that "interest shall be allowed and paid upon any overpayment in respect of any internal revenue tax at the overpayment rate . . .". No provision is given stating the income tax treatment of such interest; hence, the interest can be exempt only if it qualifies as interest paid on an obligation of the United States under 31 USC §3124.

The factual situation in Smith v. Davis, supra, is somewhat analogous to tax refunds. In this case state tax officials sought to assess for ad valorem property tax purposes the balance in an open account which the United States owed to contractors. The contractors claimed that this account
was an instrumentality of the United States and could not be included in the property to be assessed as this would be a tax on the credit of the federal government. The Supreme Court rejected this argument and stated:

[The account] is not evidenced by any written document whereby the United States, the debtor, has promised to pay this claim at a certain time in the future; nor is there any binding acknowledgement by the United States of the correctness of the claim. Conceivably the amount claimed to be due is incorrect or is subject to certain defenses or counterclaims by the United States, necessitating further settlement or adjustment. Such a unilateral, unliquidated creditor's claim, which by itself does not bind the United States and which in no way increases or affects the public debt, cannot be said to be a credit instrumentality of the United States for purposes of tax immunity.

Similarly a tax refund cannot be considered an obligation of the United States as defined in Smith v. Davis, supra, in that there is no written, binding document in which the United States has promised to pay a definite amount at a specified date.

This reasoning in Smith v Davis, supra, was recently reiterated in Rockford Life Insurance Company v. Illinois Department of Revenue, 482 US 182, 107 S.Ct. 2312, (1987) in which the Supreme Court ruled that obligations issued by the Government National Mortgage Association ("Ginnie Maes") were not exempt from state taxation in that they did not constitute obligations of the United States. Citing Smith v. Davis, supra, the Court stated that the provision in the instruments which pledged the "full faith and credit of the United States" in the payment of the interest and principal was not sufficient to render the instruments as obligations of the federal government. The GNMA certificates were held to be neither direct nor certain obligations of the United States; the government was merely the guarantor, not the obligor.

Federal Credit Unions

Similar reasoning disallows an exemption for interest paid by federal credit unions. Section 1768 of Chapter 14 of the United States Code states that "[t]he Federal credit unions . . . their property, their franchises, capital, reserves, surpluses, and other funds, and their income shall be exempt from all taxation . . ."; however, no prohibition is given that disallows a state from taxing the recipients of interest from a federal credit union on such interest. Furthermore, the interest does not qualify as interest paid on an obligation of the United States as defined in Smith v. Davis, supra.

Mutual Funds

Another question arises involving the exemption of interest from federal obligations from state taxation when these obligations are included in mutual funds. In American Bank & Trust Company, et al., v. Dallas County, et al., 463 US 855 (1983), the United States Supreme Court held a Tennessee property tax invalid that was computed on a bank's net assets without any deduction for federal obligations held by the bank. The Court stated:
Section 3701 prohibits any form of tax that would require consideration of federal obligations in computing the tax; it cannot matter whether such consideration is mandated by the tax assessor in practice or by the state statute in so many words.

This case gave rise to several state cases which ruled that statutes which disallowed a deduction for dividends paid by mutual funds which were attributable to federal obligations were unconstitutional. In one such case, Borg v. Dept. of Rev., 774 P.2d 1099 (Or. 1989), the Oregon Supreme Court ruled that dividends received from a regulated investment company (mutual fund) were exempt to the extent they represented interest paid on federal obligations held by the fund. The court referred to American Bank, supra, and concluded:

If the statutory tax immunity for United States obligations held by [American Bank] extended to the shares of [its] stockholders, a fortiori it extends to the beneficiaries of the [mutual fund] to the extent that the state could not tax their income from such obligations.

(See In re Thomas C. Sawyer Estate, 546 A.2d 784, (Vt. 1987); Yurista v. Commissioner of Revenue, 460 N.W. 2d 24, (Minn. 1990); and Capital Preservation Fund, Inc. v. Wisconsin Department of Revenue, 145 Wis.2d 841, 429 N.W.2d 551 (App. 1988)).

In South Carolina previous policy has been to allow pass-through treatment of dividends of mutual funds only if such funds were 50% or greater invested in exempt obligations. (See SC Information Letter #88-7.) The reasoning for this position was based on this state's adoption of Internal Revenue Code §852(b)(5) as part of Sections 851 through 855 dealing with regulated investment companies; however, it must be assumed that by adopting these sections, the South Carolina legislature did not intend to tax U.S. obligations which are prohibited from being taxed under federal law. "It is also a general rule of interpretation to assume that the legislature in the enactment of a statute was aware of established rules of law applicable to the subject matter of the statute" (73 Am. Jur. 2d, Statutes Section 180). "In the construction of statutes, the courts start with the assumption that the legislature intended to enact an effective law, and that the legislature is not to be presumed to have done a vain thing in the enactment of a statute. Hence, it is a general principle that the courts should, if reasonably possible to do so interpret the statute, or the provision being construed, so as to give it efficient operation and effect as a whole. An interpretation should, if possible, be avoided, under which the statute or provision being construed is defeated, or as otherwise expressed, nullified, destroyed, emasculated, repealed, explained away, or rendered insignificant, meaningless, inoperative, or nugatory." 73 Am. Jur.2d, Statutes Section 249.

Hence, upon the adoption of IRC §852, the legislature did not intend to enact a statute which would be contrary to established federal law.

**Repurchase Agreements**

The exemption from income taxation for federal obligations has also been argued to apply to repurchase agreements. These are agreements in which a seller other than the United States sells to a buyer federal obligations, and simultaneously agrees to repurchase these obligations at a future time for a price which includes interest from the date of sale. Any interest paid by the United States on such obligations during the repurchase period is paid to the seller. When the
seller repurchases the obligations, he will pay the buyer the agreed upon price plus the stated interest. These repurchase agreements are often held by individuals and mutual funds. Restrictions are usually placed on the purchaser of the obligations which may prohibit certain transfers of the securities or may disallow any security interest to be placed on the securities.

Several state courts have considered the issue of state taxation of such agreements. In Borg v. Dept. of Revenue, supra, the Oregon Supreme Court held that the interest paid at the time of repurchase to the buyer did not qualify as interest paid on federal obligations, and hence, was not exempt from state income tax. The court stated:

Whether or not the income corresponds to and serves a function equivalent to interest, that income is not paid by the United States or other issuer but by the seller at the time of the repurchase. It is not "interest" paid by the United States.

In Comptroller v. First United Bank & Trust, 320 Md. 352, 578 A.2d 192 (1990), the Court of Appeals of Maryland considered whether a trust which invested in various types of securities, including repurchase agreements (as a buyer), was subject to tax on such agreements. The Court stated that "the income to the Trust in a [repurchase agreement] is not paid by the United States to the Trust as interest on a government obligation held by the Trust, but is paid by the seller-borrower on repurchase". A similar conclusion was reached in In re Thomas C. Sawyer Estate, supra, where the Vermont Supreme Court held that income earned on a repurchase agreement did not constitute interest income attributable to federal obligations. The court concluded:

The income gained by the Trust from these arrangements is therefore interest income on the loan the Trust provides the seller, rather than interest income derived from the federal obligation, and is not exempt from state taxation under §3124(a).

(See also Capital Preservation Fund, Inc. v. Wisconsin Dept. of Revenue, supra.)

The seller in these cases will receive the exempt interest paid by the federal government and will pay taxable interest to the buyer upon repurchase of the securities. In many cases, this type of transaction is deemed to be a loan (Rev. Rul. 74-27, 1974-1 CB 24; Rev. Rul. 77-59, 1977-1 CB 196) and thus, such interest paid by the seller to the buyer at the time of repurchase is interest paid on indebtedness.

Federal Home Loan Bank Demand Deposits

A question has also arisen concerning whether interest earned on demand/overnight deposits placed with the Federal Home Loan Bank is exempt from state taxation as interest earned on a federal obligation. Section 1433 of Chapter 12 of the United States Code provides, in part:

Any and all notes, debentures, bonds and other such obligations issued by any bank, and consolidated Federal Home Loan Bank bonds and debentures, shall be exempt both as to principal and interest from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States, by any . . State, county municipality, or local taxing authority.
The South Carolina Attorney General's Office issued an opinion in which they addressed the question of whether interest received on a certificate of deposit issued by the Federal Home Loan Bank is taxable. The Attorney General's Opinion (I-OAG-76) stated that the Federal Home Loan Bank is an instrumentality of the Federal government, and thus, the interest earned on certificates of deposit issued by the Federal Home Loan Bank is exempt from South Carolina income tax. The decisions reached by other states' courts, however, bring this decision into question.

The Supreme Court of Oklahoma considered the issue of the taxation of demand deposits held by the Federal Home Loan Bank in First Federal Savings and Loan Association et al v. Oklahoma Tax Commission (Nos. 60,488 and 60,453 (1987)). In this case the court held that such deposits do not constitute obligations of the United States. The court referred to the United State Supreme Court's decision in Hibernia Savings & Loan Society v. San Francisco, 200 US 310, 26 S.Ct. 265 (1906), in which the validity of a tax imposed by the State of California on checks or orders signed by the Treasurer of the United States was questioned. The Court held that although the checks could be considered to be obligations of the United States under the letter of [31 USC §3142], they could not be considered as such under the spirit of the law. The Court relied on 28 Stat. 278, August 13, 1894, recodified as 31 USC §5154 (1983) which states:

A State or a territory or possession of the United States may tax United States coins and currency (including Federal reserve notes and circulating notes of Federal reserve banks and national banks) as money on hand or on deposit in the same way and at the same rate that the State, territory, or possession taxes other forms of money.

Furthermore, the overnight/demand deposits placed in Federal Home Loan Banks do not meet the four characteristics of obligations of the Federal government set forth in Smith v. Davis, supra.

Because of the diversity of opinion on this topic, the South Carolina legislature has decided to deal with this issue statutorily. SC Code §12-13-30 was amended to clarify that interest from demand/overnight deposits placed with Federal Home Loan banks by savings and loan associations is exempt from South Carolina income tax. This section states:

Every [savings and loan] association located or doing business within this State shall pay an income tax measured by its net income from all sources, except for income from municipal, state, or federal bonds or securities exempted by law from the tax, including interest earned on deposits at the Federal Home Loan Bank of Atlanta, or its successors, for those savings and loan associations which meet the qualified thrift lender test set forth in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (P.L. 101-73), as amended.

Interest Expense Deduction

Another issue related to the exclusion of interest from federal obligations from South Carolina gross income involves Internal Revenue Code §265 which disallows a deduction for expenses allocable to exempt income. IRC §265(a)(2) disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest from which is exempt. IRC §265(a)(3) prohibits a deduction for expenses incurred to carry shares of a regulated investment company (mutual fund) which is wholly or partly invested in exempt obligations. IRC
§265(a)(4) disallows a deduction for interest incurred or continued to purchase or carry shares of stock of a regulated investment company (mutual fund) which during the taxable year of the holder distributes exempt-interest dividends. IRC §265(b) controls the disallowance of interest expense related to exempt interest to financial institutions. Since South Carolina has also adopted this section, an adjustment must be made to federal taxable income for interest on indebtedness and other expenses incurred to carry obligations which are exempt from South Carolina income tax but are taxable for federal income tax purposes. If such interest or expenses are allocable to a mutual fund which is only partly invested in such securities, only a portion of the interest or expense incurred will be disallowed.

The amount disallowed for South Carolina income tax purposes should be computed by multiplying the interest or other expense incurred to carry the shares of the mutual fund for a given taxable year by a fraction. The numerator of the fraction is the amount of exempt-interest dividends received which are attributable to obligations which are exempt from South Carolina income taxation. The denominator is the sum of the exempt-interest dividends and taxable dividends received by the shareholder during the taxable year. (This computation is the same as described in IRC Reg §1.265-3(b)(2) for interest paid to purchase or carry obligations the income from which is exempt from federal taxation.) Any difference between this amount and the deduction claimed on the federal income tax return should be reflected as an adjustment on the taxpayer's South Carolina income tax return.

Conclusion:

The guidelines that the Commission can provide as to the taxability of interest under Chapters 7 and 13 of Title 12 of the South Carolina Code are as follows:

GENERAL RULES:

The following are exempt from South Carolina income tax:

1.) Interest from obligations issued by the State of South Carolina or any of its political subdivisions which are exempt from federal income taxes;

2.) Interest from obligations which are issued by Federal agencies or instrumentalities and contain language in their enabling legislation prohibiting the levying of a state or local tax on the interest from such obligations; and

3.) Interest from obligations of the United States which are characterized by:

   a. Written documents,

   b. The bearing of interest,

   c. A binding promise by the United States to pay specified sums at specified dates and,

   d. Specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay.
The interest from the obligations described in 1.), 2.), and 3.) above is exempt from South Carolina income taxation whether owned directly by the taxpayer or received as dividends from mutual funds. If only a portion of a mutual fund is invested in exempt obligations, the portion of dividends received which is attributable to such obligations is exempt for South Carolina income tax purposes. The fund need not be invested 50% or greater in exempt obligations in order for the taxpayer to receive pass-through treatment for the dividends received.

Expenses (including interest on indebtedness incurred or continued to purchase or carry obligations the interest from which is exempt) related to interest which is exempt for South Carolina income tax purposes but is taxable for Federal income tax purposes must be added back to compute South Carolina taxable income pursuant to IRC §265.

EXAMPLES OF EXEMPT INTEREST

The following is a list of securities the interest from which is exempt from South Carolina income tax pursuant to the above general rules, federal statute, Constitutional provisions, or State law. This list should not be considered as an exhaustive listing of all exempt securities. (As used in this section, the term "obligation" is interpreted in light of Smith v. Davis, supra.)

1. **Bonds Issued by South Carolina or its Political Subdivisions** - Interest from obligations issued by the State of South Carolina or any of its political subdivisions which are exempt from federal income tax. (SC Code Ann. §12-7-430(b)(1) (Supp. 1990).)

2. **Banks for Cooperatives** - Interest from notes, debentures, and other obligations issued by Banks for Cooperatives. (12 USC §2134.)

3. **Commodity Credit Corporation** - Interest derived from bonds, notes, debentures, and other similar obligations issued by Commodity Credit Corporation. (15 USC §713a-5.)

4. **Farm Credit Financial Assistance Corporation** - Interest derived from notes, bonds, debentures and other obligations issued by the Farm Credit Financial Assistance Corporation. (12 USC §2278b-10; 12 USC §2023.)

5. **Federal Deposit Insurance Corporation** - Interest derived from notes, debentures, bonds or other such obligations issued by Federal Deposit Insurance Corporation. (12 USC §1825.)

6. **Federal Farm Credit Banks** - Interest from consolidated system-wide notes, bonds, debentures, and other obligations issued jointly and severally under 12 USC §2153 by Banks of the Federal Farm Credit System. (12 USC §2055; 12 USC §2079; 12 USC §2098; and 12 USC §2134.)

7. **Federal Financing Bank** - Interest derived from obligations issued by the Federal Financing Bank. (12 USC §2290.)

9. **Federal Intermediate Credit Banks** - Interest from notes, bonds, debentures, and other obligations issued by Federal Intermediate Credit Banks (12 USC §2079)

10. **Federal Land Banks and Federal Land Bank Association** - Interest from notes, bonds, debentures, and other obligations issued by Federal Land Banks and Federal Land Bank Associations (12 USC §2055)

11. **Federal Savings and Loan Insurance Corporation** - Interest derived from notes, bonds, debentures, and other such obligations issued by Federal Savings and Loan Insurance Corporation (12 USC §1725(e))

12. **General Insurance Fund**:
   
a. Interest on debentures issued under the War Housing Insurance Law by the General Insurance Fund. (12 USC §1739(d).)
   
b. Interest on debentures issued by the General Insurance Fund to acquire rental housing. (12 USC §1747g(g).)
   
c. Interest on Armed Services Housing Mortgage Insurance Debentures issued by the General Insurance Fund. (12 USC §1748b(f).)

13. **GSA Public Building Trust Participation Certificates** - Interest on Series A through I, inclusive. (12 USC §3124(a).)

14. **Guam** - Interest on bonds issued by the Government of Guam. (48 USC §1423(a).)

15. **Participation Certificates in the Federal Assets Financing Trust** - Interest from Series A through D Participation Certificates, due in 1987 and 1988, and income from Participation Certificates in the Federal Assets Liquidation Trust, Series B, due in 1987, issued by the Federal National Mortgage Association as trustee (the Government National Mortgage Association is the current trustee) under (12 USC §1717(c)); (31 USC §3124(a).)

16. **Production Credit Association** - Interest from notes, debentures, and other obligations issued by Production Credit Association. (12 USC §2098.)

17. **Puerto Rico** - Interest derived from bonds issued by the Government of Puerto Rico. (48 USC §745.)
18. Resolution Trust Corporation - Interest from obligations issued by the Resolution Trust Corporation. (12 USC §1441a(g).)

19. Student Loan Marketing Association - Interest derived from obligations issued by the Student Loan Marketing Association (20 USC §1087-2(l))

20. Tennessee Valley Authority - Interest from bonds issued by the Tennessee Valley Authority. (16 USC §831n-4(d).)


22. United States Treasury Bonds, Bills, Certificates and Savings Bonds - Interest from Treasury Bonds, Treasury Bills, certificates and savings bonds. (31 USC §3124(a).)

23. Virgin Islands - Interest from bonds issued by the Government of the Virgin Islands. (48 USC §1574(b)(ii)(A).)

EXAMPLES OF NON-EXEMPT INTEREST

Interest from the following is taxable to South Carolina:

1. Repurchase Agreements - The interest received by a "buyer" in a repurchase agreement transaction of a federal obligation is not exempt from South Carolina income taxation.

2. Federal Tax Refunds - Interest paid on federal tax refunds is not exempt from South Carolina income tax.

3. Federal and State Credit Unions - Interest from deposits with federal and state credit unions.

4. Federal Home Loan Mortgage Association (Freddie Mac) - Interest from obligations issued by the Federal Home Loan Mortgage Association.


7. Inter-American Development Bank - Interest on obligations issued by the Inter-American Development Bank.

9. Municipal obligations of states other than South Carolina - Interest from obligations issued by other states and municipalities.


SOUTH CAROLINA TAX COMMISSION

s/S. Hunter Howard Jr.
S. Hunter Howard, Jr., Chairman

s/A. Crawford Clarkson Jr.
A. Crawford Clarkson, Jr., Commissioner

s/T. R. McConnell
T. R. McConnell, Commissioner

Columbia, South Carolina
September 18, 1991