BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WOODLAND PRODUCTION CREDIT ASSOCIATION)

Appearances:

For Appellant! Koster & Kohlmeier and Bayley Kohlmeier, Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel; Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the protests of Woodland Production Credit Association to proposed assessments of additional franchise taxes in the amounts of $469.76 for the income and taxable year 1950; $422.27 for the income year 1950, taxable year 1951; $436.00 for the income year 1951, taxable year 1952; and $511.27 for the income year 1952, taxable year 1953.

Appellant was chartered in 1933 by the Governor of the Farm Credit Administration under the Farm Credit Act of 1933, It has been doing business in this State since 1933 and began filing tax returns with the 1950 income year, Under the Farm Credit Act of 1933, production credit associations may be organized by ten or more farmers desiring to borrow money for agricultural purposes and may be chartered by the Governor upon his approval of the articles of the association.

During the period in question production credit associations were authorized to issue two classes of stock, designated as Class A and Class B shares. Class A shares were issuable only to the Federally-owned Production Credit Corporation, although they are now also available to private investors, Class B shares could be held only by farmer borrowers and individuals eligible to become borrowers. Retirement of Class A shares held by the Production Credit Corporation could be required by that agency whenever an association had resources available for that purpose.. Just prior to the year 1950 the Class A shares issued by Appellant had been retired and during the years at issue the Production Credit Corporation held no shares of stock in the Appellant.

Appeal of Woodland Production Credit Association

Appellant, in its returns, reported income from interest on loans, interest on government bonds and loan service fees. It claimed all of this income as a deduction under Section 24121(n) of the Revenue and Taxation Code. It did not, accordingly, report any net income and paid only the minimum tax. The Franchise Tax Board disallowed the deduction for the interest on the government bonds.

Two issues are presented in this appeal: (1) is Appellant taxable under Section 23183 of the Revenue and Taxation Code (formerly Section 4 of the Bank and Corporation Franchise Tax Act) and (2) if so, is the interest received on government bonds deductible under Section 24121(n)?

A determination of the first issue depends upon the meaning of Section 63 of the Farm Credit Act of 1933 (12 U.S.C.A. Sec. 1138C). For the years in question it read:

> "The Central Bank for Cooperatives, and the Production Credit Corporations, Production Credit Associations, and Banks for Cooperatives, organized under this chapter, and their obligations, shall be deemed to be instrumentalities of the United States, and as such, any and all notes, debentures, bonds, and other such obligations issued by such banks, associations, or corporations 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 by any State, territorial or local taxing authority. Such banks, associations, and corporations, their property, their franchises, capital, reserves, surplus, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, territorial, or local taxing authority; except that any real property and any tangible personal property of such banks, associations, and corporations shall be subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed. The exemption provided herein shall not apply with respect to any Production Credit Association or its property or income after the stock held in it by the Production Credit Corporation has been retired, or with respect to the Central Bank for Cooperatives, or any Production Credit Corporation or Bank for Cooperatives or its property or income after the stock held in it by the United States has been retired, " (Emphasis added.)

For the year 1950, the taxing statute involved provided:

> "Every financial corporation doing business within the limits of this State, taxable under the provisions of Section 16 of Article XIII of the Constitution of this State, shall annually pay to the State for the privilege of exercising its corporate franchises within this State, a tax according to or measured by its net income..." (Section 4 of the Bank and Corporation Franchise Tax Act,)

With respect to the remaining years involved, 1951, 1952, and 1953, the successor to this statute provides:

> "An annual tax is hereby imposed upon every financial corporation doing business within the limits of this State and taxable under the provisions of Section 16 of Article XIII of the Constitution of this State for the privilege of exercising its corporate franchises within this State, according to or measured by its net income..." (Section 23183 of the Revenue and Taxation Code).

The parties are agreed that Section 63 of the Farm Credit Act of 1933 exempted Appellant from the tax so long as part of its stock was held by the Production Credit Corporation. The specific question is whether the "consent provision", applicable after that stock is retired, is sufficiently broad to allow the imposition of this tax. It is, of course, a fundamental principle of law that an instrumentality of the Federal Government can be taxed only in the manner permitted by Congress. McCulloch v. Maryland, 4 Wheat (U.S.) 316, 4 L. Ed. 579; Austin v. Alderman of Boston, 7 Wall, (U.S.) 694, 19 L. Ed. 224. We must, therefore, determine whether or not Congress has consented to the taxation of Appellant in the manner attempted by the Franchise Tax Board.

Appellant argues that since the phrase "their franchises, capital, reserves, surplus and other funds" in the exemption provision of Section 63 is not repeated in the consent provision, Congress did not consent to a franchise tax. It is, however, difficult to believe that Congress would adopt so casual and oblique an approach to carry out an intention to continue the exemption of those items. If the consent provision had simply stated "The exemption provided herein shall not apply with respect to any Production Credit Association..." it would be reasonably clear that the entire

exemption was withdrawn. The phrase "with respect to" gives a connotation sufficiently broad to include all taxes which the association must pay. It seems reasonable that Congress added "...or its property or income" in an attempt to establish beyond doubt the withdrawal of the entire exemption. It is hardly credible that by the simple addition of these words the exemption of franchises, capital, reserves, surplus and other funds was intended to be continued,

The limitation which the Appellant seeks to read into the "consent" language of Section 63 was not in fact contemplated by Congress and has not been discerned by the courts.

In the report of the House Committee on Agriculture, House Report No, 171, dated May 29, 1933, accompanying H.R. 5790 (the Farm Credit Act of 1933), the section here in question was explained as follows:

> "Section 63 provides that the corporations organized under the act shall be exempt from taxes, except that their real property and tangible personal property may be taxed, The tax exemption with respect to any Production Credit Association and its property and income is not to apply after stock held in it by the Production Credit Corporation has been retired..."

The report of the Senate Committee on Banking and Currency, Senate Report No. 124, dated June 6, 1933, contained substantially the same language.

Similarly, Senate Report No. 1201, dated July 28, 1955, accompanying H. R. 5168 (the Farm Credit Act of 1955), which among other things amended the section here in question, left no doubt of the understanding of Congress. The report stated:

> "Under present law a production credit association is exempt from most taxes so long as the production credit corporation owns any of its stock, When all stock of the association owned by the corporation is retired, such tax exemption would terminate." (Emphasis added.)

In Zeiss v. Brenham Production Credit Ass'n., 259 S. W. 2d 299, the Court of Civil Appeals of Texas, after stating the "all important question" to be "whether the Capital Stock and Surplus of a Production Credit Association...is subject to taxation by the city in which it has its principal office, after it has repaid or 'retired' all money invested in it by

the Federal Government and its agencies,.," held that such "Capital Stock and Surplus becomes subject to taxation, in keeping with whatever species of Corporation or Association that a Production Credit Association actually is for tax purposes." That this decision was ultimately reversed (see 264 S.W. 2d 95) on the ground that the association was not "a banking corporation" within the meaning of the local taxing act in no wise impugns the interpretation placed upon the Federal statute,

In Southwest Washington Production Credit Ass'n. v. Fender, 150 P, 2d 983, the Supreme Court of Washington, in the course of determining whether a production credit association is an instrumentality of the United States, and hence exempt from payment of the state corporate license fees, said that "Its franchise is, by the express provisions of the Farm Credit-exempt from state taxation, and all state tax burdens other than as to its real property and tangible personal property, so long as any of its stock is held by the production credit corporation." (Emphasis added.)

The only support for the interpretation urged by the Appellant is a letter of the Attorney General of the State of Georgia, dated January 31, 1955, addressed to the Commissioner of Revenue, in which he reversed an earlier opinion. In the earlier opinion the Attorney General analyzed the Federal provision in the light of the objection now made by Appellant and concluded that "A verbatim repetition of the terms.., stating the scope of the exemption from taxation is not required...to remove the exemption from taxation when the members assume full ownership of the association stock." In his subsequent letter he stated that the "right of a State to impose a franchise tax must come from Congressional consent and that consent has not been given as to these Associations." Since the letter failed to state the reasons for belatedly concluding that consent had not been given, and is not in accord with the Congressional reports and judicial decisions mentioned herein, it is not persuasive.

Having concluded that the Appellant is not exempt from the tax we must now consider its alternative contention that the income from United States bonds is deductible under former Section 24121n of the Revenue and Taxation Code. That section allowed a deduction of income as follows:

> "In the case of other associations organized and operated in whole or in part on a cooperative or a mutual basis, all income resulting from or arising out of business activities for or with their members carried

on by them or their agents; or when done on a nonprofit basis for or with nonmembers."

In order to secure funds from the Federal Intermediate Credit Bank for loans to its members, as well as for other purposes, Appellant is required to maintain an investment in United States Government bonds. It contends, therefore, that the income from these bonds is deductible as income "resulting from or arising out of business activities for or with" its members. The Franchise Tax Board relies upon an opinion of the Attorney General of this State, dated April 29, 1955, which states that such interest is not deductible even though the investments are required by law. The Attorney General indicates that the interest is from activities which are only incidental to the main purpose of the associations and should be regarded as income from activities conducted with non-members for profit,

Appellant points to no authority construing this section but argues that we should give a broad interpretation to the words "resulting from or arising out of" the business activities for its members, As the Attorney General points out in his opinion, and as we have previously pointed out in Appeal of California Pine Box Distributors, September 15, 1949, in a broad sense, all of the income of a cooperative results from business activities carried on for its members and yet it is apparent that the section does not contemplate a blanket deduction, We agree with the Attorney General that this interest is not deductible under Section 24121n.

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Woodland Production Credit Association to proposed assessments of additional franchise taxes in the amounts of $469.76 for the income and taxable year 1950; $422.27 for the income year 1950, taxable year 1951; $436.00 for the income year 1951, taxable

year 1952 and in the amount of $511.27 for the income year 1952, taxable year 1953, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of February 1958, by the State Board of Equalization.

Ged. R. Reilly, Chairman

Robert E. McDavid, Member

J. H. Quinn, Member

Paul R. Leake, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L. Pierce, Secretary