

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
H. Lon Henry) No. 90R-0476
)
)

Representing the Parties:

For Appellant: H. Lon Henry

For Respondent: John A. Stilwell, Jr., Counsel

Counsel for Board
of Equalization: Tommy Leung,
Staff Counsel

OPINION

This appeal is made pursuant to section 19324 (formerly section 19057), subdivision (a),¹ of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the

¹ Unless otherwise specified, all section references hereinafter in the text of this opinion are to sections of the Revenue and Taxation Code as in effect for the years in issue.

claims of H. Lon Henry for refund of personal income tax in the amounts of \$162, \$147, \$99, and \$24 for the years 1984, 1985, 1986, and 1987, respectively.

The issue presented in this appeal is whether appellant's interest and dividend income from mutual funds whose assets were repurchase agreements to buy and sell federal government obligations is exempt from California personal income tax.

Appellant filed timely² returns for the appeal years, reporting interest and dividends received from the Capital Preservation Fund II and the Benham Capital Preservation Fund (mutual funds). Subsequently, on May 15, 1989, and May 22, 1989, appellant filed amended returns for the appeal years, claiming that the interest and dividends from these mutual funds were from federal obligations and, thus, exempt from California taxation. Respondent denied the refund claims because appellant failed to prove that at least 50 percent of the assets held by the two mutual funds were federal obligations whose income was exempt from state taxation (see Rev. & Tax. Code, § 17145) and because the 1984 claim was untimely.³ This appeal followed.

Appellant contends 100 percent of the mutual funds' assets were repurchase agreements to buy and sell federal government obligations or securities and cites Davis v. Michigan Dept. of Treasury, 489 U.S. 803 [103 L.Ed.2d 891](1989), in support of his position. Furthermore, appellant makes constitutional arguments, charging that respondent's action is in violation of the equal protection, due process, and supremacy clauses of the United States Constitution.

Generally, interest and dividends derived from federal government obligations or securities are exempt from the California income tax. (See Rev. & Tax. Code, § 17145; 31 U.S.C. § 3124.) Section 17145 provides, in part, that if at least 50 percent of the value of the total assets of a mutual fund consists of obligations the interest from which is exempt from taxation, that mutual fund shall be qualified to pay tax-exempt dividends to its shareholders. (Rev. & Tax Code, § 17145, subd. (a).) Thus, the tax-exempt status of interest derived from such obligations is allowed to pass through to the individual shareholder of a mutual fund. (Brown v. Franchise Tax Board, 197 Cal.App.3d 300 [242 Cal.Rptr. 810](1987).)⁴ To claim the exemption, the shareholder must have received a written notice

² Appellant filed an automatic extension (form FTB 3502) for the 1984 tax year; thus, that return was not due until October 15, 1985.

³ In light of the fact that appellant filed an automatic extension for 1984, respondent now concedes that appellant's refund claim for 1984 was timely.

⁴ Once the mutual fund meets the threshold criterion of section 17145, however, only a portion of its dividends, equal to the percentage shown to be from exempt government obligations, is exempt from California taxation. (Rev. & Tax. Code, § 17145, subd. (b)(1); Appeal of Richard R. and Diane K. Smith, 91-SBE-005, Oct. 9, 1991.)

from the issuing company, designating the dividends as exempt. (Rev. & Tax. Code, § 17145, subd. (b)(1).) Recently, this state's highest court held that federal law⁵ does not prohibit California from taxing income derived from repurchase agreements involving federal securities, as income from such repurchase agreements is not interest on "obligations of the United States Government." (See Bewley v. Franchise Tax Board, 9 Cal.4th 526 [37 Cal.Rptr.2d 298](1995).

Therefore, since appellant did not provide us with any written statement(s) from the mutual funds stating that the dividends he received therefrom were tax-exempt, and in light of the Bewley decision, we conclude that respondent properly denied appellant's refund claims. Moreover, we find that appellant's reliance on the Davis decision to be misplaced. In Davis, the United States Supreme Court held that a Michigan statute which permitted retirees from state employment to receive pension income free from state taxes, but which made no such accommodation for federal retirees, was unconstitutional. The Davis case is not applicable here because respondent's determination was not based on whether the mutual funds' assets were federal or state obligations, but whether the interest and dividends from those assets were from federal obligations. Clearly, as held by this state's Supreme Court, they were not. (See Bewley v. Franchise Tax Board, supra.) Finally, with regard to appellant's constitutional arguments, article III, section 3.5, of the California Constitution precludes this board from deciding constitutional issues and from declaring statutory provisions to be unconstitutional. (See Appeal of Aimor Corp., Cal. St. Bd. of Equal., Oct. 26, 1983.)

Accordingly, respondent's action in this matter must be sustained.

ORDER

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 19333 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of H. Lon Henry for refund of personal income tax in the amounts of \$162, \$147, \$99, and \$24 for the years 1984, 1985, 1986, and 1987, respectively, be and the same is hereby sustained.

(. . continued)

⁵ Namely, 31 U.S.C. § 3124(a).

Done at Sacramento, California, this 14th day of March, 1996, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson present.

Johan Klehs _____, Chairman

Ernest J. Dronenburg, Jr. _____, Member

Dean F. Andal _____, Member

Brad J. Sherman _____, Member

Rex Halverson* _____, Member

*For Kathleen Connell, per Government Code section 7.9.