

**STATE TAXATION OF INCOME FROM
"REPURCHASE AGREEMENTS":
LOEWENSTEIN V. DEPARTMENT
OF REVENUE**

[T]he power to tax involves the power to destroy. . . . [I]f the states may tax one instrument, employed by the government in the execution of its powers, they may tax any and every other instrument. . . . [T]hey may tax all the means employed by the government, to an excess which would defeat all the ends of government. [The American people] did not design to make their government dependent on the states.¹

INTRODUCTION

Through the years, the issue of intergovernmental tax immunity addressed in *McCulloch v. Maryland*² has expanded into other contexts, including the use of "repurchase agreements."³ A standard repurchase agreement is a transaction whereby a holder of federal securities sells the obligations to a party for cash.⁴ In this transaction, the buyer promises to sell the security back to the seller at an agreed upon date and price, including a specified amount of interest.⁵ After World War II, dealers in federal securities began to use repurchase agreements to finance their positions.⁶ Large financial institutions later began to use repurchase agreements to finance their own dealer positions as well as their own government portfolios.⁷

With this increase in the repurchase agreement market, states have increasingly begun to tax the interest earned from the transactions as a source of revenue.⁸ State taxation of income derived from repurchase agreements involving federal securities has become a source of controversy because of section 3124 of Title 31 of the United States Code ("section 3124") which exempts federal securities from

1. *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431-32 (1819).

2. 17 U.S. (4 Wheat.) 316 (1819).

3. See *McCulloch*, 17 U.S. (4 Wheat.) at 431-32; see *infra* notes 4-16.

4. See Neb. Rev. Rul. 22-85-1 (Jan. 26, 1985) (LEXIS, Sttax library, Neb. file); see *infra* note 27 and accompanying text.

5. See *Loewenstein v. Department of Revenue*, 244 Neb. 82, 85, 504 N.W.2d 800, 801-2 (1993), *cert. granted*, 114 S. Ct. 1215 (1994).

6. Appellant's Brief, *Department of Revenue v. Loewenstein*, 244 Neb. 82, 504 N.W.2d 800 (1993), *cert. granted*, 114 S. Ct. 1215 (1994) (No. 93-823) (Brief to United States Supreme Court).

7. *Id.*

8. See *infra* notes 103-60 and accompanying text.

state taxation.⁹ In Nebraska, interest income from repurchase agreements was first taxed in 1985 pursuant to Nebraska Department of Revenue Ruling 22-85-1 ("Ruling 22-85-1").¹⁰

In *Loewenstein v. Department of Revenue*,¹¹ the Nebraska Supreme Court addressed whether Ruling 22-85-1 was valid.¹² The issue confronted by the supreme court in *Loewenstein* was one of first impression.¹³ The court held that income received from investments in federal securities through repurchase agreements is not subject to state taxation pursuant to section 3124.¹⁴ As such, the court declared Ruling 22-85-1 invalid.¹⁵

This Note will first explain the court's holding in *Loewenstein*.¹⁶ This Note will then trace the historical development of section 3124 along with the body of case law that has interpreted this section.¹⁷ This Note will then discuss how other courts have handled the issue presented in *Loewenstein*.¹⁸ This Note concludes that the court applied a correct analysis in striking down Ruling 22-85-1.¹⁹

FACTS AND HOLDING

John Loewenstein, a Nebraska citizen, invested in two mutual funds: the Trust for Short-Term United States Government Securities and the Trust for United States Treasury Obligations ("Trusts").²⁰ These Trusts were "no-load, open-end, diversified investment companies whose primary objective [was] to receive current income from ownership of U.S. Government securities and obligations."²¹ The Trusts did not invest in any other securities.²² Pursuant to Nebraska Department of Revenue Ruling 22-85-1 ("Ruling 22-85-1"), Loewenstein was required to pay Nebraska state income tax on the interest

9. See *infra* notes 103-60 and accompanying text; see 31 U.S.C. § 3124 (1988); see *infra* note 81 and accompanying text.

10. Appellant's Brief, *Department of Revenue v. Loewenstein*, 244 Neb. 82, 504 N.W.2d 800 (1993), *cert. granted*, 114 S. Ct. 1215 (1994) (No. 93-823) (Brief to United States Supreme Court); see Neb. Rev. Rul. 22-85-1 (Jan. 26, 1985) (LEXIS, Sttax library, Neb. file).

11. 244 Neb. 82, 504 N.W.2d 800 (1993), *cert. granted*, 114 S. Ct. 1215 (1994).

12. *Loewenstein v. Department of Revenue*, 244 Neb. at 84, 504 N.W.2d at 802 (1993), *cert. granted*, 114 S. Ct. 1215 (1994).

13. *Id.* at 89, 504 N.W.2d at 804.

14. *Id.* at 90, 504 N.W.2d at 805.

15. *Id.*

16. See *infra* notes 20-71 and accompanying text.

17. See *infra* notes 76-102 and accompanying text.

18. See *infra* notes 103-60 and accompanying text.

19. See *infra* notes 161-98 and accompanying text.

20. *Loewenstein v. Department of Revenue*, 244 Neb. 82, 83, 504 N.W.2d 800, 801 (1993), *cert. granted*, 114 S. Ct. 1215 (1994).

21. *Id.* at 84, 504 N.W.2d at 802.

22. *Id.* at 85, 504 N.W.2d at 802.

income he received from his investments in the Trusts.²³ Revenue Ruling 22-85-1 provides in relevant part as follows:

The interest income received from repurchase agreements involving obligations of the United States government is income to the investor who provides the funds as a loan secured by government securities. This interest income which is received from repurchase agreements involving obligations of the United States government is subject to the Nebraska individual income tax. It is not to be subtracted from a taxpayer's federal taxable income on the Nebraska return.²⁴

The Trusts which Loewenstein purchased invested solely in United States government securities both directly and indirectly through repurchase agreements.²⁵ The typical repurchase agreement used by the Trusts was comprised of a two-part transaction.²⁶ First, the holder of the federal securities sold the government obligations to the Trust in exchange for cash.²⁷ Second, the Trust contemporaneously agreed to resell the government obligations back to the initial holder of the securities, and the holder agreed to repurchase at the original sale price, plus an agreed upon amount of interest to be paid at a specified future date.²⁸ This interest paid by the holder was less than the interest rate accruing on the government security.²⁹ The Trusts took actual delivery of the securities through the Federal Reserve book entry system.³⁰ However, the interest earned on the

23. *Id.* at 83, 504 N.W.2d at 801; see Neb. Rev. Rul. 22-85-1 (Jan. 26, 1985) (LEXIS, Sttax library, Neb. file); see *infra* note 24 and accompanying text.

24. Neb. Rev. Rul. 22-85-1 (Jan. 26, 1985) (LEXIS, Sttax library, Neb. file); *Loewenstein*, 244 Neb. at 83, 504 N.W.2d at 801.

25. *Loewenstein*, 244 Neb. at 85, 504 N.W.2d at 802.

26. *Id.*, 504 N.W.2d at 801. Revenue Ruling 22-85-1 characterizes repurchase agreements providing in relevant part:

A repurchase agreement is essentially a short-term loan, bearing interest at a specified rate, whereby an owner of government or agency securities obtains funds from a customer, a financial institution, or a broker/dealer. The loan is secured by certain Treasury Bills or other obligations of the federal government owned by the borrower. The terms of the repurchase agreement generally provide for the sale of the securities with a prompt repurchase by the owner. The party providing the funds does not receive the actual federal government obligations securing the investment, but does receive a collateral receipt identifying the securities pledged to or sold to the party providing the funds. The risk of ownership and title to the securities does not shift from the operator of a repurchase pool to the investor providing short-term funds.

Neb. Rev. Rul. 22-85-1 (Jan. 26, 1985) (LEXIS, Sttax library, Neb. file).

27. *Loewenstein*, 244 Neb. at 85, 504 N.W.2d at 802.

28. *Id.*

29. *Id.*

30. *Id.*

United States government securities remained the income of the holder.³¹

In May of 1988, Loewenstein initiated a declaratory judgment action in the District Court of Lancaster County, Nebraska asking the court to declare Ruling 22-85-1 invalid.³² Subsequently, the district court held that Ruling 22-85-1 violated both section 3124 of Title 31 of the United States Code ("section 3124") and the Supremacy Clause of the United States Constitution.³³ The Nebraska Department of Revenue ("Department") appealed the district court's decision regarding Revenue Ruling 22-85-1 to the Nebraska Supreme Court.³⁴

The supreme court considered whether section 3124 prevented the State of Nebraska from taxing Loewenstein's interest income derived from investments in federal securities through repurchase agreements.³⁵

In urging reversal of the district court's decision, the Department reasoned that the repurchase agreements were essentially collateralized loans secured by federal obligations.³⁶ The Department argued that if the repurchase agreements were secured loans, the income received from the agreements would be interest payments on a loan, not interest income earned directly from federal securities.³⁷ The Department argued further that because the trusts received their income from private parties, not the federal government, a "state tax on such income did not involve the consideration of a U.S. obligation, or the interest thereon, in computing the tax."³⁸

However, the court was unpersuaded by the Department's arguments and affirmed the district court's holding that Ruling 22-85-1 was invalid.³⁹ The court began its analysis by discussing the statu-

31. *Id.* at 83, 504 N.W.2d at 801. See Kenneth S. Gerstein & Stuart M. Strauss, *Repurchase Agreements*, in INVESTMENT COMPANIES 1986, at 1-2 (PLI Corporate Law and Practice Course Handbook Series No. 397, 1986).

32. *Loewenstein*, 244 Neb. at 83, 504 N.W.2d at 801. This action was filed under the Administrative Procedure Act. *Id.* In the action, Loewenstein also sought to have another Revenue Ruling relating to trust taxation declared invalid pursuant to 31 U.S.C. § 3124 and the Supremacy Clause of the United States Constitution. *Id.* The pleadings were later amended to include a request for a ruling on Revenue Ruling 22-85-1. *Id.* at 84, 504 N.W.2d at 801.

33. *Loewenstein*, 244 Neb. at 84, 504 N.W.2d at 802. The district court ruled that the other Revenue Ruling was also void, however the Department did not appeal this decision. *Id.*, 504 N.W.2d at 802.

34. *Loewenstein*, 244 Neb. at 84, 504 N.W.2d at 802. The Department only appealed the district court's decision regarding Ruling 22-85-1. *Id.*, 504 N.W.2d at 802.

35. *Loewenstein*, 244 Neb. at 84, 504 N.W.2d at 802. The court applied a de novo standard of review. *Id.*

36. *Loewenstein*, 244 Neb. at 89, 504 N.W.2d at 804.

37. *Id.*

38. *Id.*

39. *Id.* at 90, 504 N.W.2d at 805.

tory history and relevant case law regarding section 3124.⁴⁰ The court noted that section 3124 provides that United States obligations are exempt from state or local taxation.⁴¹ The court also stated that section 3124 is a recodification of section 742 of Title 31 of the United States Code ("section 742") without substantive change.⁴² As a result, the court noted that the United States Supreme Court's interpretation of section 742 was binding in its own interpretation of section 3124.⁴³ The court recognized that the body of case law applying section 742 had described the section as a "sweeping" and "broad" exemption.⁴⁴ Furthermore, the court explained that Congress intended section 742 to "prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary credit."⁴⁵

Because the court addressed an issue of first impression, it referenced case law from other jurisdictions which had confronted the same issue.⁴⁶ The court noted that other state and federal courts had applied a rationale similar to the one urged by the Department.⁴⁷ The court explained that these jurisdictions determined that income derived from a repurchase agreement involving federal securities was not exempt from state income taxation.⁴⁸ However, the court believed that the rationale applied by these other jurisdictions was "based entirely on whether that party [was] deemed the true, or direct, owner of the securities."⁴⁹ The court rejected the argument that direct ownership determines whether income from repurchase transactions is exempt under section 3124.⁵⁰ Instead, the court focused on the congressional intent of section 3124, which was to prevent state taxation which reduces the market value or the investment attractiveness of United States securities.⁵¹

The court concluded by reviewing the expert testimony of Peter Sternlight, Executive Vice President of the Federal Reserve Bank of

40. *Id.* at 87, 504 N.W.2d at 803.

41. *Id.* See 31 U.S.C. § 3124 (1988).

42. *Loewenstein*, 244 Neb. at 87-88, 504 N.W.2d at 804.

43. *Loewenstein*, 244 Neb. at 88, 504 N.W.2d at 804.

44. *Id.*

45. *Id.* at 84, 504 N.W.2d at 804 (quoting *Memphis Bank & Trust Co. v. Garner*, 549 U.S. 392, 396 (1983)).

46. *Id.* at 89, 504 N.W.2d at 804.

47. *Id.* at 90, 504 N.W.2d at 805.

48. *Id.* at 89, 504 N.W.2d at 804.

49. *Id.* at 90, 504 N.W.2d at 805.

50. *Id.*

51. *Id.*

New York.⁵² Sternlight testified that any impairment of the repurchase market would reduce the investment attractiveness for dealer underwriting of federal obligations, thereby increasing interest costs incurred by the United States Department of the Treasury.⁵³ Sternlight also characterized repurchase agreements as an essential element in the efficient functioning of the U.S. government securities markets.⁵⁴ In addition, Sternlight stated that state laws, like Ruling 22-85-1, which have the effect of classifying repurchase agreements as collateralized loans, would prevent the Federal Reserve from using repurchase agreements to make short-term adjustments in the nation's money supply.⁵⁵

Based upon the statutory history and judicial interpretation of section 3124, the analysis provided by other jurisdictions, and the expert testimony of Sternlight, the court concluded that Ruling 22-85-1 was invalid.⁵⁶ Consequently, the court ruled that Loewenstein's income received from the Trusts' activity in the repurchase market involving federal securities was exempt from state taxation pursuant to section 3124.⁵⁷

Judge D. Nick Caporale, joined by Judge John Grant, dissented.⁵⁸ Judge Caporale examined the essence of the repurchase transactions and determined that the agreements were essentially collateralized loans secured by federal obligations.⁵⁹ Therefore, Judge Caporale reasoned that the income Loewenstein received from the repurchase agreements was not earned directly from federal obligations, but rather was derived from collateralized loans secured by the federal obligations.⁶⁰ Judge Caporale noted that the Trusts essentially "receive[d] a fixed rate of return which [bore] no relationship either to the value of the securities which [made] up the trusts' funds or to the income the securities produce[d] for the seller, or more accurately, the seller-repurchaser."⁶¹ As such, Judge Caporale explained that not only did the seller carry the risk of market fluctuations, but the seller also had the right to substitute one federal obligation for another.⁶²

52. *Id.* at 86, 504 N.W.2d at 803. This testimony was taken from another case, *Department of Revenue, Fla. v. Page*, 541 So. 2d 1270 (Fla. Dist. Ct. App. 1989), in which the same issue was litigated. *Id.*

53. *Loewenstein*, 244 Neb. at 86, 504 N.W.2d at 803.

54. *Id.*

55. *Id.*

56. *Id.* at 90, 504 N.W.2d at 805.

57. *Id.*

58. *Id.* at 91-95, 504 N.W.2d at 805-7 (Caporale, J., dissenting).

59. *Id.* at 91, 504 N.W.2d at 805 (Caporale, J., dissenting).

60. *Id.* at 94, 504 N.W.2d at 807 (Caporale, J., dissenting).

61. *Id.* at 91, 504 N.W.2d at 806 (Caporale, J., dissenting).

62. *Id.*

In reaching his conclusion, Judge Caporale explained that nine of the ten other appellate courts which had considered this issue had held that repurchase agreement income was not exempt from state taxation.⁶³ Judge Caporale relied particularly upon *Everett v. Department of Revenue and Finance*⁶⁴ in which the Iowa Supreme Court stated that:

The State's tax did not consider, either directly or indirectly, the federal obligations or the interest paid on them in calculating the Everetts' tax. Instead, the tax was based on the interest paid by private seller-repurchasers pursuant to a private sector loan agreement in which federal obligations served as collateral. In such a situation, neither the federal obligations nor the interest thereon is considered in calculating the state income tax.⁶⁵

Judge Caporale also noted that these courts found that section 3124 only exempts the interest income received by the seller, the party who actually owns the securities.⁶⁶

Judge Caporale then argued that characterizing repurchase agreements as collateralized loans would not impair the Federal Reserve's ability to make fluctuations in the nation's money supply.⁶⁷ Relying upon *Hammond Lead Products, Inc. v. Tax Commissioners*,⁶⁸ Judge Caporale noted that the Federal Reserve's regulation of the money supply "relates to commercial banks and the general scheme of lending limits; it has no bearing on the Internal Revenue Code or the judicial interpretation of repurchase agreements."⁶⁹ Although Loewenstein asserted that repurchase agreements are an essential tool for maintaining mutual fund liquidity, Judge Caporale noted that government obligations are themselves very liquid and that a trust fund could achieve greater liquidity by borrowing against its own holdings of government obligations.⁷⁰ Thus, Judge Caporale reasoned that Ruling 22-85-1 was valid.⁷¹

63. *Id.*

64. 470 N.W.2d 13 (Iowa 1991).

65. *Everett v. Department of Revenue & Finance*, 470 N.W.2d 13, 15 (Iowa 1991); *Loewenstein*, 244 Neb. at 94, 504 N.W.2d at 807 (Caporale, J., dissenting).

66. *Loewenstein*, 244 Neb. at 92, 504 N.W.2d at 806 (Caporale, J., dissenting).

67. *Id.* at 93-4, 504 N.W.2d at 807 (Caporale, J., dissenting).

68. 575 N.E.2d 998 (Ind. 1991).

69. *See Hammond Lead Prod., Inc. v. Tax Comm'rs*, 575 N.E.2d 998 (Ind. 1991); *Loewenstein*, 244 Neb. at 94, 504 N.W.2d at 807 (Caporale, J., dissenting).

70. *Loewenstein*, 244 Neb. at 94, 504 N.W.2d at 807 (Caporale, J., dissenting).

71. *Id.* at 94-95, 504 N.W.2d at 807 (Caporale, J., dissenting).

BACKGROUND

States have increasingly begun to tax interest income earned from repurchase agreements.⁷² Those who argue against such a tax assert that it is invalid under section 3124 of Title 31 of the United States Code ("section 3124").⁷³ Those who argue in support of such a tax assert that section 3124 is inapplicable because the tax is not applied to the original holder of the securities.⁷⁴ In an attempt to resolve this dispute, state courts have been forced to analyze the legislative history of section 3124, United States Supreme Court interpretations of section 3124, and other state court decisions addressing this issue.⁷⁵

THE LEGISLATIVE HISTORY OF 31 U.S.C. § 3124

Section 3124 is a recodification of section 742 of Title 31 of the United States Code ("section 742").⁷⁶ Until 1959, section 742 provided that "all stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority."⁷⁷ In 1959, Congress amended section 742 by adding that "[t]his exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax."⁷⁸ The United States Supreme Court has consistently interpreted this language as prohibiting "state taxes imposed on federal obligations, either directly, or indirectly as part of a tax on the taxpayer's total property or assets."⁷⁹

When Congress recodified section 742 as section 3124, it deleted the words "directly or indirectly" as surplusage.⁸⁰ Section 3124 provides in relevant part:

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.⁸¹

72. See *infra* notes 103-60 and accompanying text.

73. See *infra* notes 76-160 and accompanying text; see 31 U.S.C. § 3124 (1988); see *infra* note 81.

74. See *infra* notes 76-160 and accompanying text.

75. See *infra* notes 76-160 and accompanying text.

76. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 859 (1983). The legislative intent of the recodification was not to substantively change the law. 96 Stat. 1062.

77. *American Bank & Trust Co.*, 463 U.S. at 859.

78. *Id.*

79. *Id.*

80. Act of Sept. 13, 1982, Pub. L. No. 97-258, 1982 U.S.C.C.A.N. (96 Stat.) 1988.

81. 31 U.S.C. § 3124(a) (1988).

Section 3124 also creates exceptions allowing states to impose nondiscriminatory franchise taxes, other nonproperty taxes assessed on a corporation, and estate or inheritance taxes.⁸²

UNITED STATES SUPREME COURT DECISIONS REGARDING THE BREADTH OF THE SECTION 3124 EXEMPTION

In *Memphis Bank and Trust Co. v. Garner*,⁸³ the Supreme Court addressed whether a Tennessee tax on banks violated the immunity of federal obligations from state and local taxation under section 742.⁸⁴ Tennessee imposed a tax on a bank's net earnings, excluding from the bank's net earnings obligations of Tennessee and its political subdivisions.⁸⁵ Memphis Bank and Trust Company filed an action in the Chancery Court of Shelby County, Tennessee seeking recovery of the taxes it paid on interest income earned from federal securities, arguing that the tax violated section 742.⁸⁶ The chancery court ruled in favor of Memphis Bank and Trust, but on appeal the Tennessee Supreme Court reversed.⁸⁷ The United States Supreme Court noted probable jurisdiction and agreed to hear the case.⁸⁸

In its analysis, the Court stated that section 742 was essentially a restatement of the constitutional rule it announced in *McCulloch v. Maryland*,⁸⁹ that "[s]tates may not impose taxes directly on the Federal Government, nor may they impose taxes the legal incidence of which falls on the Federal Government."⁹⁰ The Court noted that it had previously interpreted section 742 as a "broad" exemption of federal securities from state taxation.⁹¹ The Court also stated that it would interpret the exemption "in accord with the long established Congressional intent to prevent taxes which diminish in the slightest degree the market value or the investment attractiveness of obligations issued by the United States in an effort to secure necessary

82. 31 U.S.C. § 3124(a)(1)(2) (1988).

83. 459 U.S. 392 (1983).

84. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 393 (1983).

85. *Id.*

86. *Id.*

87. *Memphis Bank & Trust Co. v. Garner*, 624 S.W.2d 551, 552 (Tenn. 1981), *probable jurisdiction noted by*, 456 U.S. 943 (1982), *rev'd*, 459 U.S. 392 (1983).

88. *Memphis Bank & Trust Co. v. Garner*, 456 U.S. 943 (1982).

89. 17 U.S. (4. Wheat.) 316 (1819).

90. See *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819); *Memphis Bank & Trust Co.*, 459 U.S. at 397. See *United States v. County of Fresno*, 429 U.S. 452, 459 (1977).

91. *Memphis Bank & Trust Co.*, at 395. The Court also noted that the exemption not only extends to Treasury notes and bills, but also to obligations of such instrumentalities of the United States, such as Farm Credit Banks. *Id.* at 396 n.5.

credit."⁹² As a result, the Court invalidated the Tennessee tax on the grounds that it impermissibly discriminated against federal obligations in favor of securities issued by Tennessee and its political subdivisions.⁹³

Shortly after the Court announced its decision in *Memphis Bank and Trust Co.*, the Court in *American Bank and Trust Co. v. Dallas County*,⁹⁴ considered whether a Texas tax on bank shares violated section 742.⁹⁵ In calculating the value of the bank shares subject to the tax, Texas did not deduct from the bank's net assets the value of federal obligations held by the bank.⁹⁶ The Texas Court of Civil Appeals held that the tax did not violate section 742.⁹⁷ The United States Supreme Court reversed the court of civil appeals by relying upon the legislative intent and the plain language of the 1959 amendment to section 742.⁹⁸

In invalidating the state tax, the Court reasoned that Texas took into account federal securities at least indirectly in computing the tax.⁹⁹ The Court stated that the language of section 742 covered all forms of taxation and was not consistent with implied exceptions.¹⁰⁰ The Court noted that "[f]rom the specific exceptions for franchise and estate and inheritance taxes, and the conspicuous omission of shares taxes from that group, only one inference is possible: Congress meant to bar shares taxes to the extent they consider federal obligations in the computation of the tax."¹⁰¹ As such, the Court found that Congress intended to invalidate all state taxes which compute either directly or indirectly the value of federal obligations.¹⁰²

92. *Memphis Bank & Trust Co.*, 459 U.S. at 396 (quoting *Smith v. Davis*, 323 U.S. 111, 117 (1944)).

93. *Id.* at 398-99. The Court noted that the bank tax was impermissible unless the tax was a nondiscriminatory franchise tax or other nonproperty tax pursuant to section 742. *Id.* at 396.

94. 463 U.S. 855 (1983).

95. *American Bank & Trust Co.*, 463 U.S. at 857-58.

96. *Id.* at 860. Texas imposed a property tax on bank shares and another tax on banks' real estate holdings. *Id.* at 859.

97. *Bank of Texas v. Childs*, 615 S.W.2d 810 (Tex. Civ. App. 1982), *inj. granted*, 634 S.W.2d 2 (Tex. App. 5 Dist. 1982), *cert. granted in part*, 459 U.S. 966 (1982), *rev'd*, 463 U.S. 855 (1983).

98. *American Bank & Trust Co.*, 463 U.S. at 873.

99. *Id.* at 863.

100. *Id.* at 864.

101. *Id.*

102. *Id.* at 867.

OTHER DECISIONS REGARDING REPURCHASE AGREEMENTS AND SECTION 3124

Legislative intent and the Court's interpretation of section 3124 have been used by other courts in determining whether state taxation of income derived from repurchase agreements involving federal obligations is valid.¹⁰³ Nine of ten other appellate courts have held that income derived from repurchase agreements is not exempt from state taxation.¹⁰⁴ These courts have noted that the original holder of the federal securities in the repurchase transaction bears the risk of market fluctuations and receives the interest payments from the federal government.¹⁰⁵ Therefore, these courts have reasoned that the holder is the only party who may claim the section 3124 exemption.¹⁰⁶

In *Hammond Lead Products v. Tax Commissioners*,¹⁰⁷ the State of Indiana imposed a tax upon interest income received pursuant to repurchase agreements involving federal securities.¹⁰⁸ Hammond Lead entered into repurchase agreements with its bank whereby the bank would transfer United States Treasury Bills and Notes to Hammond Lead and Hammond Lead would agree to transfer them back to the bank at a certain date.¹⁰⁹ The bank held the obligations separately on the bank's records for the Hammond Lead account.¹¹⁰ The bank also gave Hammond Lead safekeeping receipts for these obligations.¹¹¹ Hammond Lead paid the Indiana adjusted income tax on the income derived from the transactions, but filed claims for a refund with the Indiana Department of Revenue.¹¹² The department disagreed with Hammond Lead that the income was exempt from Indiana taxation under section 3124 and noted that Hammond Lead did

103. See *infra* notes 104-60 and accompanying text.

104. *Hammond Lead Prod., Inc. v. Tax Comm'rs*, 575 N.E.2d 998 (Ind. 1991); *Everett v. Department of Revenue and Fin.*, 470 N.W.2d 13 (Iowa 1991); *Comptroller v. First United Bank*, 578 A.2d 192 (Md. 1990); *Borg v. Department of Revenue*, 774 P.2d 1099 (Or. 1989); *Department of Revenue v. Page*, 541 So. 2d 1270 (Fla. Dist. Ct. App. 1989); *Massman Constr. Co. v. Director of Revenue*, 765 S.W.2d 592 (Mo. 1989); *Capital Preservation Fund, Inc. v. Department of Revenue*, 429 N.W.2d 551 (Wis. Ct. App. 1988); *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); *Andras v. Department of Revenue*, 506 N.E.2d 439 (Ill. App. 2d 1987), *cert. denied*, 485 U.S. 960 (1988). *Contra Matz v. Department of Treasury*, 401 N.W.2d 62 (Mich. Ct. App. 1986) (holding that income derived from repurchase agreements involving federal obligations is exempt from state taxation).

105. See *Hammond Lead Prod., Inc.*, 575 N.E.2d at 1001; *Capital Preservation*, 429 N.W.2d at 554-55; *Andras*, 506 N.E.2d at 443-44.

106. See *Hammond Lead Prod., Inc.*, 575 N.E.2d at 1001; *Capital Preservation*, 429 N.W.2d at 554-55; *Andras*, 506 N.E.2d at 443-44.

107. 575 N.E.2d 998 (Ind. 1991).

108. *Hammond Lead Prod., Inc.*, 575 N.E.2d at 999-1000.

109. *Id.* at 999.

110. *Id.*

111. *Id.*

112. *Id.* at 1000.

not own the United States obligations.¹¹³ As a result, the department contended that Hammond Lead could not claim the exemption.¹¹⁴ The state tax court ruled in favor of the department.¹¹⁵ Hammond Lead appealed to the Indiana Supreme Court.¹¹⁶

On appeal, the Indiana Supreme Court noted that Indiana did not tax the interest paid by the U.S. government to the bank.¹¹⁷ The court ruled that Indiana merely taxed the interest income received by Hammond Lead pursuant to its repurchase agreement with the bank.¹¹⁸ The court noted that in determining ownership:

[A] court may consider whether the party claiming such [exemption] bears the risk of market fluctuations, whether that party has the ability to sell the securities to a third party, whether the seller or the United States government pays the interest income and whether the obligations must be considered in computing the tax.¹¹⁹

The court recognized that the bank reserved the right to substitute securities of equal value and quality.¹²⁰ Furthermore, the court noted that Hammond Lead could not sell the securities during the term of the agreement.¹²¹ Thus, the court characterized the repurchase transaction as a collateralized loan for tax purposes.¹²²

In *Capital Preservation Fund, Incorporated v. Department of Revenue*,¹²³ the Court of Appeals of Wisconsin also concluded that interest income received from repurchase agreements involving federal obligations is taxable.¹²⁴ The court of appeals addressed whether the Wisconsin tax statutes applied to income received from trusts that invested in repurchase agreements involving federal obligations.¹²⁵ The trust funds at issue invested solely in U.S. obligations, both directly

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.* at 999-1000.

117. *Id.* at 1001.

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.* The Indiana Tax Court concluded:

[T]he repurchase agreement with Hammond Lead removes the elements of ownership and the source of interest necessary for exemption. Although the Bank and Hammond Lead may have effectuated a sale for other purposes, for tax purposes the result is, in effect, a collateralized loan. Therefore, Hammond Lead's claims for refund were appropriately denied.

Id. (quoting *Hammond Lead Prod., Inc. v. Tax Comm'rs*, 549 N.E.2d 424, 429 (Ind. Tax 1990), *aff'd*, 575 N.E.2d 998 (Ind. 1991)).

122. *Hammond Lead Prod., Inc.*, 575 N.E.2d at 1001.

123. 429 N.W.2d 551 (Wis. Ct. App. 1988).

124. *Capital Preservation Fund, Inc.*, 429 N.W.2d at 555.

125. *Id.* at 553.

and through repurchase agreements.¹²⁶ The trial court held that Wisconsin's taxation of this income violated section 3124.¹²⁷ The Wisconsin Department of Revenue appealed.¹²⁸

On appeal, the Department asserted that the repurchase agreements were essentially secured loans, and that the interest income received from the agreements was interest received from a loan, not interest received from the ownership of federal securities.¹²⁹ In its analysis, the court noted that:

In reviewing similar transactions involving municipal bonds, Federal courts have consistently held that the Federal income tax exemption provided for income received from State or municipal obligations . . . is available only to the taxpayer who actually owns the securities—i.e., the taxpayer who has the right to dispose of them and who bears the risk of a profit or loss.¹³⁰

The court concluded that the trusts did not accept any of the risks of ownership involved with the federal obligations and therefore characterized the agreements as collateralized loans rather than sales.¹³¹ The court noted that the income received from the repurchase agreements is not directly attributable to the federal securities.¹³² Instead, the court held that the income was interest received on a collateralized loan.¹³³

In *Matz v. Department of Treasury*,¹³⁴ the Michigan Court of Appeals reached a result contrary to *Hammond Lead Products and Capital Preservation Fund, Inc.*¹³⁵ In *Matz*, a Michigan taxpayer filed suit seeking a refund of Michigan state taxes that she paid.¹³⁶ The State

126. *Id.* at 552-53.

127. *Id.* at 553.

128. *Id.*

129. *Id.* at 554.

130. *Id.* at 554-55 (quoting *Andras v. Department of Revenue*, 506 N.E.2d 439 (Ill. App. 2d 1987), *cert. denied*, 485 U.S. 960 (1988)).

131. *Id.* (relying on *In re Thomas C. Sawyer Estate*, 546 A.2d 784 (Vt. 1987); *Andras v. Department of Revenue*, 506 N.E.2d 439 (Ill. App. 2d 1987), *cert. denied*, 485 U.S. 960 (1988)). The court quoted the Vermont Supreme Court in *In re Thomas C. Sawyer Estate*:

When holding federal obligations as part of a repurchase agreement, the Trust holds them, in essence, as security for a loan to the original purchaser of the . . . obligations . . . The income gained by the Trust from these arrangements is . . . 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.

Capital Preservation Fund, Inc., 429 N.W.2d at 555.

132. *Id.*

133. *Id.*

134. 401 N.W.2d 62 (Mich. Ct. App. 1986).

135. *See Matz*, 401 N.W.2d at 65; *see infra* notes 136-46 and accompanying text.

136. *Matz*, 401 N.W.2d at 62.

of Michigan had attempted to tax the income that she received from her investments in a trust that invested solely in federal securities, both directly and through repurchase agreements.¹³⁷ The tax tribunal ordered the Michigan Department of Treasury to refund the taxes based on the exemption in section 3124.¹³⁸ The department appealed to the Michigan Court of Appeals.¹³⁹ On appeal, the department argued that the mutual fund, not the investors in the fund, owned the securities.¹⁴⁰ Therefore, the department asserted that because the investor is merely the owner of shares in a mutual fund, the investor "holds shares in the fund in basically the same manner that [an investor] would hold shares in . . . any . . . corporate entity."¹⁴¹ The court of appeals rejected this reasoning and held that the department cannot tax shares of mutual funds that invest solely in federal obligations, both directly and through repurchase agreements.¹⁴²

In its analysis, the court noted that "the [S]tate of Michigan may not . . . directly or indirectly diminish in the slightest degree the market value or the investment attractiveness of the underlying United States Government obligations."¹⁴³ The court further noted that, as a matter of law, any direct or indirect tax on federal obligations affects the market value and investment attractiveness of the securities.¹⁴⁴ The court also stated that the effect of the Michigan's tax was directly traceable to the ownership of, and income derived from, federal securities which are exempt from state taxation.¹⁴⁵ The court concluded by rejecting the technical distinction of direct ownership advanced by the department and held that the taxpayer was entitled to the exemption under section 3124.¹⁴⁶

In *Citizens National Bank of Waco v. United States*,¹⁴⁷ the United States Court of Claims also classified a repurchase transaction as a sale and not as a loan.¹⁴⁸ Citizens National Bank initiated an action seeking the recovery of federal income tax deficiencies and interest

137. *Id.* at 63.

138. *Id.* at 62.

139. *Id.*

140. *Id.* at 64.

141. *Id.*

142. *Id.* at 64-65.

143. *Id.* at 65.

144. *Id.*

145. *Id.*

146. *Id.* See, William F. Hagerty, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities*, 37 VAND. L. REV. 401, 420 (1984) (arguing that repurchase agreements should be characterized as a sale on a purchase of a security).

147. 551 F.2d 832 (Ct. Cl. 1977).

148. *Citizens Nat'l Bank of Waco v. United States*, 551 F.2d at 838 (Ct. Cl. 1977).

assessed against it by the Internal Revenue Service ("I.R.S.").¹⁴⁹ Citizens National Bank entered into a repurchase transaction with American Amicable Life Insurance Company involving Texas municipal bonds.¹⁵⁰ Under the terms of the repurchase agreement, Citizens National Bank could have required American Amicable to repurchase the bonds on demand for par value, but Citizens National Bank was not required to resell the bonds to American Amicable.¹⁵¹ Both parties believed that Citizens National Bank was free to sell the securities to a third party; however, the court noted that Citizens National Bank neither attempted to determine the actual market price of the bonds nor did it ever attempt to sell the bonds.¹⁵² Citizens National Bank treated the income derived from the transactions as tax-exempt income on its federal tax returns.¹⁵³ As a result, the I.R.S. assessed tax deficiencies against Citizens National for two years.¹⁵⁴ The I.R.S. denied Citizens National Bank's refund claims.¹⁵⁵ Subsequently, Citizens National Bank filed an action in the court of claims.¹⁵⁶

In its analysis, the court examined the economic substance of the transaction between the two parties.¹⁵⁷ The court noted that some of the features of the transaction favored interpreting the transaction as a loan rather than a sale.¹⁵⁸ However, based upon the facts of the case, the court reasoned that the transaction was a sale and not a loan made by American Amicable to Citizens National Bank.¹⁵⁹ The court determined that Citizens National Bank was the true owner of the bonds and was therefore entitled to deduct the interest earned from the transaction from its federal income taxes.¹⁶⁰

ANALYSIS

In *Loewenstein v. Department of Revenue*,¹⁶¹ the Nebraska Supreme Court examined the congressional intent and case law regarding section 3124 of Title 31 of the United States Code ("section 3124"), along with the decisions of other jurisdictions, and invalidated Nebraska Department of Revenue Ruling 22-85-1 ("Ruling 22-85-

149. *Id.* at 833.

150. *Id.* at 834.

151. *Id.* at 842.

152. *Id.* at 836.

153. *Id.* at 836-37.

154. *Id.*

155. *Id.* at 837.

156. *Id.*

157. *Id.* at 836.

158. *Id.* at 842.

159. *Id.* at 843.

160. *Id.*

161. 244 Neb. 82, 504 N.W.2d 800 (1993), *cert. granted*, 114 S. Ct. 1215 (1994).

1").¹⁶² The practical effect of the supreme court's ruling was to exempt income received from investments in repurchase agreements from Nebraska taxation.¹⁶³ In reaching its decision, the court departed from the rationale applied in other jurisdictions by interpreting the exemption in section 3124 broadly.¹⁶⁴

Judge D. Nick Caporale dissented.¹⁶⁵ Judge Caporale applied the traditional approach employed by nine other jurisdictions.¹⁶⁶ Judge Caporale reasoned that the repurchase agreements were collateralized loans and not sales of federal securities.¹⁶⁷ In addition, Judge Caporale reasoned that the Nebraska tax did not consider the federal obligations in the computation of the tax.¹⁶⁸

Despite Judge Caporale's objections, the court's holding in *Loewenstein* was proper.¹⁶⁹ The court correctly interpreted the congressional intent and relevant case law applying section 3124.¹⁷⁰ In so doing, the court properly reasoned that direct ownership of the obligations should not determine whether the income from repurchase transactions involving federal obligations should be exempt from state taxation under section 3124.¹⁷¹ In addition, the court correctly considered the potential impact of state taxation upon income derived from repurchase transactions.¹⁷²

In contrast to Judge Caporale's dissent, the court gave greater weight to the congressional intent behind section 742 of Title 31 of the United States Code ("section 742"), section 3124, and certain United States Supreme Court interpretations of these sections.¹⁷³ In section 3124, Congress declared that "[t]he 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."¹⁷⁴ In *Memphis*

162. *Loewenstein v. Department of Revenue*, 244 Neb. 82, 90, 504 N.W.2d 800, 805, cert. granted, 114 S. Ct. 1215 (1994). See *supra* notes 11-57 and accompanying text.

163. *Loewenstein*, 244 Neb. at 90, 504 N.W.2d at 804. See *supra* note 56 and accompanying text.

164. *Loewenstein*, 244 Neb. at 90, 504 N.W.2d at 805. See *supra* notes 40-45 and accompanying text.

165. *Loewenstein*, 244 Neb. at 91, 504 N.W.2d at 805 (Caporale, J., dissenting).

166. *Id.* at 91-5, 504 N.W.2d at 805-07 (Caporale, J., dissenting). See *supra* notes 58-71 and accompanying text.

167. *Loewenstein*, 244 Neb. at 91, 504 N.W.2d at 805 (Caporale, J., dissenting). See *supra* notes 58-71 and accompanying text.

168. *Loewenstein*, 244 Neb. at 94, 504 N.W.2d at 807 (Caporale, J., dissenting). See *supra* notes 58-71 and accompanying text.

169. See *infra* notes 170-98 and accompanying text.

170. See *infra* notes 173-98 and accompanying text.

171. See *infra* notes 173-98 and accompanying text.

172. See *infra* notes 173-98 and accompanying text.

173. See *Loewenstein*, 244 Neb. at 90, 504 N.W.2d at 805. See *supra* notes 39-51 and accompanying text.

174. 31 U.S.C. § 3124 (1988). See *supra* note 81 and accompanying text.

Bank and Trust Co. v. Garner,¹⁷⁵ the United States Supreme Court stated that section 742 established a "broad" exemption of federal securities from state taxation.¹⁷⁶ In *Memphis Bank and Trust*, the Supreme Court also noted that the congressional intent of section 3124 was to prevent state taxation which diminishes in the slightest degree the investment attractiveness of federal obligations.¹⁷⁷ In *American Bank and Trust Co. v. Dallas County*,¹⁷⁸ the Supreme Court further noted that "[u]nder the plain language of the 1959 amendment . . . the tax is barred regardless of its form if federal obligations must be considered, either directly or indirectly, in computing the tax."¹⁷⁹ Similarly, in *Matz v. Department of Treasury*,¹⁸⁰ the Michigan Court of Appeals noted that, as a matter of law, any direct or indirect tax on federal securities impacts the market value and investment attractiveness of these securities.¹⁸¹

Based on the history of section 3124, the Nebraska Supreme Court reasoned that the real issue was not who directly owned the obligations, but whether taxation of this form of income considered the federal obligations in computing the tax.¹⁸² As a result, the court properly noted that "the income received by the appellee in this case, at the very least, is considered indirectly in computation of the tax."¹⁸³

Under this view, the Nebraska Supreme Court correctly reasoned that Ruling 22-85-1 would undermine congressional intent by placing a burden upon the market for federal securities.¹⁸⁴ Peter Sternlight testified that "repurchase agreements involving federal securities are essential to the efficient functioning of the government securities markets."¹⁸⁵ Sternlight also testified that these transactions are an essential method for dealers to finance their positions in federal obligations and that these dealers underwrite thirty-five to seventy-five percent of new government issues.¹⁸⁶ Furthermore, Sternlight testified that any impairment of the repurchase market would dimin-

175. 459 U.S. 392 (1983).

176. *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 395 (1983). See *supra* note 91 and accompanying text.

177. *Memphis Bank & Trust Co.*, 459 U.S. at 396. See *supra* note 92 and accompanying text.

178. 463 U.S. 855 (1983).

179. *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983).

180. 401 N.W.2d 62 (Mich. Ct. App. 1986).

181. *Matz v. Department of Treasury*, 401 N.W.2d 62, 65 (Mich. Ct. App. 1986). See *supra* note 144 and accompanying text.

182. *Loewenstein*, 244 Neb. at 90, 504 N.W.2d at 805.

183. See *id.*

184. See *id.*

185. *Id.* at 86, 504 N.W.2d at 803.

186. *Id.*

ish the investment attractiveness for dealers to underwrite federal obligations, thereby adding to financing costs.¹⁸⁷

Although it is true that characteristics of a repurchase agreement can either be classified as a sale or loan, Judge Caporale should have rejected this technical distinction and declared Ruling 22-85-1 void because it considers the federal obligations in computation of the tax.¹⁸⁸ Instead, Judge Caporale viewed the repurchase transactions as collateralized loans.¹⁸⁹ Therefore, Judge Caporale reasoned that the interest earned from a collateralized loan is not precluded from state taxation by section 3124.¹⁹⁰ By relying upon the direct ownership issue, Judge Caporale did not adequately address the congressional intent and relevant case law applying section 3124.¹⁹¹

In *Citizens National Bank of Waco v. United States*,¹⁹² the United States Court of Claims rejected the technical distinction of ownership advanced by Judge Caporale.¹⁹³ The court in *Citizens National Bank of Waco* examined the economic substance of the repurchase agreement and classified the transaction as a sale and not a loan.¹⁹⁴ Similarly, in *Loewenstein*, the transfer of ownership was actually recorded in the Federal Reserve book entry system and cash was exchanged between the buyer and seller.¹⁹⁵

By focusing on the direct ownership issue, Judge Caporale ignored the precedent established by the Supreme Court regarding the interpretation of section 3124.¹⁹⁶ Judge Caporale also failed to resolve Sternlight's testimony in his dissent.¹⁹⁷ For these reasons, the court was correct in placing a greater emphasis upon the congressional intent of section 3124 and rejecting the technical distinction of direct ownership.¹⁹⁸

CONCLUSION

In *Loewenstein v. Department of Revenue*,¹⁹⁹ the Nebraska Supreme Court confronted the issue of whether section 3124 of Title

187. *Id.*

188. *See supra* notes 133-60 and accompanying text.

189. *Loewenstein*, 244 Neb. at 91, 504 N.W.2d at 805 (Caporale, J., dissenting).

190. *Id.*

191. *See supra* notes 76-102 and accompanying text.

192. 551 F.2d 832 (Ct. Cl. 1977).

193. *See Citizens Nat'l Bank of Waco v. United States*, 551 F.2d 832, 843 (Ct. Cl. 1977). *See supra* notes 147-60 and accompanying text.

194. *Citizens Nat'l Bank of Waco*, 551 F.2d at 843.

195. *Loewenstein*, 244 Neb. at 85, 504 N.W.2d at 802.

196. *See supra* notes 58-71 and accompanying text.

197. *See supra* notes 58-72 and accompanying text.

198. *See supra* notes 161-98 and accompanying text.

199. 244 Neb. 82, 504 N.W.2d 800 (1993), *cert. granted*, 114 S. Ct. 1215 (1994).

31 of the United States Code ("section 3124") prevents the State of Nebraska from imposing a tax on income derived from repurchase agreements involving federal obligations.²⁰⁰ Although the court recognized case law from other jurisdictions that reached an opposite conclusion, it independently analyzed the facts, section 3124, and relevant case law to reach a proper conclusion that Nebraska Department of Revenue Ruling 22-85-1 was invalid.²⁰¹ As a result, the court held that the income John Loewenstein received from his repurchase transactions involving federal obligations was exempt from Nebraska state income tax pursuant to section 3124.²⁰² The Nebraska Department of Revenue applied for a writ of certiorari to the United States Supreme Court. The Supreme Court has granted certiorari, heard oral arguments, and will soon decide whether the Nebraska Supreme Court's decision was correct.

Many states and governmental entities will undoubtedly be awaiting the Supreme Court's resolution of this issue. The intergovernmental tax immunity issue involved in *Loewenstein* has been litigated virtually since our nation was formed.²⁰³ The Supreme Court's resolution of this issue will affect not only local tax revenues, federal debt financing costs, and the ability of the Federal Reserve to regulate the money supply, but will also affect individual investors who participate in the federal security markets through mutual funds offering access through smaller denominations.²⁰⁴ If the Court follows the reasoning of the Nebraska Supreme Court, its ruling would add certainty to the repurchase market by promoting investment safety and stability.²⁰⁵ The United States Supreme Court's characterization of a repurchase agreement as a sale and not a loan would mean that "the Fed more easily could execute short-term domestic monetary policy, securities dealers more easily could acquire funds to finance the floatation of new government debt, and institutional investors could enjoy more liquidity and security in their short-term investments."²⁰⁶ This characterization would also have the long-term effect of protecting many buyers against issuer fraud and require issuers to provide buyers with enough information to alert them to any latent risks associated with the repurchase market.²⁰⁷ Thus, the United States

200. *Loewenstein v. Department of Revenue*, 244 Neb. at 84, 504 N.W.2d at 802.

201. *Id.* at 90, 504 N.W.2d at 805.

202. *Id.*

203. See *supra* notes 72-160 and accompanying text.

204. See *supra* notes 52-55 and accompanying text.

205. See William F. Hagerty, *Lifting the Cloud of Uncertainty Over the Repo Market: Characterization of Repos as Separate Purchases and Sales of Securities*, 37 VAND. L. REV. 401, 423 (1984).

206. Hagerty, 37 VAND. L. REV. at 423.

207. Hagerty, 37 VAND. L. REV. at 424.

Supreme Court could resolve a split among the jurisdictions in an economically favorable way by following the reasoning of the Nebraska Supreme Court.

Shad E. Sumrow—'96