

Opinion No. 59-157

October 5, 1959

BY: HILTON A. DICKSON, JR., Attorney General

TO: Mr. J. C. Hester State Investment Officer Santa Fe, New Mexico

{*244} This is in response to your recent inquiries asking for our opinion in regard to the following questions:

1. When the State Investment Council purchases interest-bearing securities at a discount, i.e., less than the amount which will be due thereon at their maturity, does the amount of the discount, when paid at maturity, constitute a capital gain or income?
2. Does the State Investment Council have the authority to purchase interest-bearing securities at a premium, i.e., at a price greater than the face value of the security?
3. If the answer to 2 is "Yes", is the amount of the premium, when paid by you, chargeable to the capital account, or deducted from income, when earned?
4. When the State Investment Council purchases non-interest - bearing United States Treasury short-term bills at a discount, does the amount of the discount, when paid at maturity, constitute a capital gain or income?

Our answers to your questions are as follows:

1. Capital gain.
2. Yes.
3. See explanation that follows.
4. Income.

Before we answer the specific questions you have raised, it might be well to point out that under the authorities contained in Sections 11-2-8.4 through 11-2-8.19, N.M.S.A., 1953 Comp., (P.S.), the State Investment Council acting through you and in accordance with the terms and conditions of these sections, acts as a trustee of the State permanent fund and as such, the actions of the Council in the investment of such fund should be gauged by the law applicable to trustees generally unless limited by statute.

Turning now to your first question, we are of the opinion that when the Council, acting through you, purchases securities at a discount, i.e., below the face value thereof, the amount of the discount, when paid at maturity, constitutes a capital gain and not income. Although there is still some difference of opinion of the courts as to whether a

trustee should credit the amount of a discount to principal, thus making it a capital gain, or to interest, thus making it income, the more recent decisions and the weight of authority {*245} has held that such amount is an accretion to principal constituting a capital gain and not to be considered as income. See Restatement, Trusts, 2d., Sec. 240, Comment h; 3 Scott on Trusts (1956 ed.), Sec. 240.2; **Old Colony Trust Company v. Comstock**, 290 Mass. 377, 195 N.E. 389 (1935); **Merchantile-Commerce Bank and Trust Company v. Morse**, 356 Mo. 336, 201 S.W. 2d 915 (1947).

In answer to your second question, we are of the opinion that you have authority to purchase interest-bearing securities at a premium, i.e., above the face value of the security, if the premium price that you pay is the market price of the security. Section 11-2-8.13 states that investments made pursuant to the above-cited sections ". . . shall be made with the exercise of that degree of judgment and care, under circumstances then prevailing, when men of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived".

Thus the statute has adopted for the purposes of investment of the permanent fund, the prudent man rule of investments that is applicable to trustees generally. Under this rule, it is generally held that a trustee can properly invest in securities, the purchase price of which is greater than the face value of the security, or, as you have stated, at a premium. See Restatement, Trusts, 2d, Sec. 239, Comment f; 3 Scott on Trusts (1956 ed.), Secs. 239-239.4; **Central Hanover Bank and Trust Company v. Bruns**, 16 N.J. Super. 199, 84 A. 2d 475 (1951).

In answer to your third question, it is our opinion that the amount of the premium, when paid by you, must be chargeable to the capital account. The amount of the premium constitutes a capital investment since the actual principal price of the security at the time you purchase it is greater than the face value. However, you have no authority to deplete the permanent fund. Therefore, you should not pay the entire amount of the interest received from the security to the income account, but should properly retain so much of the income as is necessary to amortize on the maturity of the security the amount of the premium paid. See Restatement, Trusts, 2d, Sec. 239, Comment f.

In your fourth question you asked whether the amount of the discount on short-term U.S. Treasury bills, which bear no interest, is to be considered as a capital gain or income. Logically, this amount should probably be considered as a capital gain, since it represents an accretion to the principal of the bill and is not designated as interest. Therefore, if strict logic were followed, the answer to this question would be the same as in question 1 regarding interest-bearing securities, i.e., the amount of the discount is a capital gain. However, the courts, in dealing with the disposition of the discount on noninterest-bearing securities, have held that, in effect, the discount is the only income received from the security and should, therefore, be considered as income and disposed of accordingly. See 3 Scott on Trusts (1956 ed.); *Will of Wehner*, 238 Wis.

557, 300 N.W. 241 (1941). Therefore, you should apply this amount to your income account.

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