

Opinion No. 71-113

October 4, 1971

BY: OPINION OF DAVID L. NORVELL, Attorney General

TO: Mr. Jesse D. Kornegay State Treasurer State Land Office Building Santa Fe, N.M. 87501 and Mr. Robert G. Mead State Investment Officer Executive Legislative Building Santa Fe, NM. 87501

QUESTIONS

QUESTIONS

May capital gains realized on the sale of common stock be used to offset losses on the sale of fixed income securities such as bonds, notes, debentures and mortgages if the transaction is a simultaneous one?

CONCLUSION

Yes; see Analysis.

OPINION

{*168} ANALYSIS

The question at issue is whether a 1965 amendment to Article XII, Section 7, New Mexico Constitution, would have the effect of making the transactions described below result in a constitutional loss which would have to be offset with monies from the general fund.

PROPOSED TRANSACTIONS

Annual
Income

SELL: \$ 335,000 Bond A 3 3/4% due 5/1/88 at 62 \$ 12,562

Cost basis \$ 333,207

Proceeds 207,700

Realized Loss \$ 125,507

SELL: \$ 450,000 Stock A at 100 \$ 3,600

Proceeds \$ 450,000

Cost basis 319,500

Realized Gain \$ 130,500

TOTAL PROCEEDS \$ 657,700

TOTAL INCOME 16,162

NET GAIN 4,993

BUY: \$ 335,000 Bond B 8 1/2% due 8/1/2011 at 100 27,219
Cost: \$ 335,000
BUY: \$ 9,681
STOCK YIELDING STOCK B 3%
Cost: \$ 322,700
TOTAL INCOME: \$ 36,900
INCREASED ANNUAL INCOME: \$ 20,739 (128%)

ANOTHER PROPOSED TRANSACTIONS

Annual
Income
SELL: \$ 1,550,000 Bond C 5-5/8% 8/1/95 at 77 \$ 84,375
Cost basis \$ 1,491,250
Proceeds 1,155,000
Realized Loss 336,250
SELL: \$ 18,200 Shares Stock C \$ 26,208
at 52
Proceeds \$ 946,400
Cost basis 589,521
Realized Gain \$ 356,879
TOTAL PROCEEDS \$ 2,101,400
TOTAL INCOME 110,583
NET GAIN 20,629

(Amount by which corporate sector book value is increased upon reinvestment.)

BUY: \$ 1,500,000 Bond D 7 3/4% 6/1/2001 at 97 \$ 120,125
Cost: \$ 1,503,500
BUY: STOCK YIELDING STOCK D 2.8%
16,741
Cost: \$ 597,900
TOTAL INCOME \$ 136,866
INCREASED ANNUAL INCOME
\$ 26,283 (24%)

{*170} You note that these transactions are actual examples of transactions that could have been consummated and that they would have increased the income to the beneficiaries of the permanent fund. The stocks would be sold under the permissive authorization for such sales when there is a change in the investment quality of the stock. You also point out that the transaction would be a **simultaneous** one.

The 1965 amendment to Article XII, Section 7, New Mexico Constitution added the following provision:

The state investment officer, **in order to realize increased income**, may, with the approval of the state investment council, sell **interest bearing notes or securities** at

less than their original acquisition cost, providing the proceeds are immediately reinvested in sufficiently higher yielding **interest bearing notes or securities**, to provide for a portion of the increased interest income **to be amortized over the life of the new investment which will restore to the corpus of the fund the amount of the capital loss realized** on the sale of the original investment. (Emphasis added.)

Actually it is not possible to truly amortize an investment which is not a fixed income security. Common and preferred stocks are not fixed income securities and thus cannot be amortized on any planned basis. Accordingly, what the 1965 amendment refers to is sale of fixed income securities such as bonds, notes, debentures and mortgages and subsequent purchase of other securities of the same type with a higher yield so that when a portion of the increased interest income is amortized the corpus of the fund is restored. In such a situation, this provision states in effect that there is no loss which must be made up from the general fund.

The remainder of Article XII, Section 7 is the same as it was prior to the 1965 amendment (other than an increase in the maximum holdings of corporate securities from twenty-five percent to fifty percent) and thus our 1961 advice to the State Investment Council is applicable. Rather than paraphrase the advice given to the State Investment Officer by this office on August 3, 1961, we quote it as follows:

This is written in response to your letter concerning the sale of securities by the Council at a loss. You have pointed out that Article XII, Section 7 provides that all losses, however occurring, shall be reimbursed by the state. If you will check the pocket part of Volume 1 of the New Mexico Statutes, you will see that that constitutional section was amended in 1958 and the loss provision of Article XII, Section 7 now in effect, reads as follows:

All losses from such interest bearing notes or securities which have definite maturity dates shall be reimbursed by the state.'

You will note from this sentence that this loss provision does not now apply to stocks. Common and Preferred stocks, in their ordinary form do not have definite maturity dates and they would, therefore, not be subject to this loss provision.

We will consider this loss provision in regard to interest bearing securities having definite maturity dates. Section 11-2-8.10, N.M.S.A., 1953 Compilation (P.S.), provides as follows:

Securities or investments purchased or held may be sold or exchanged for other securities and investments; Provided, however, that no sale or exchange shall be at a price less than the going market at the time the securities or investments are sold or exchanged.'

This statute merely provides that the securities may not be sold for less than the going market for those securities at the time of sale. It does not require that a price be obtained which is equal to the original purchase price.

Considering the constitutional provision and the above cited statute together, we are of the opinion that the loss mentioned in the constitutional section refers to the entire sale or transaction rather than to ~~{*171}~~ individual securities or to securities of a corporation or to securities of a certain type. That is to say that if the Council were to sell government bonds having a maturity date of 1995 at a 1 point loss but at the same time and in the same transaction sold government bonds or, for that matter, corporate bonds having a maturity date of 1985 at a 1 point gain, the entire transaction must be considered to test whether a loss has been incurred within the meaning of Article XII, Section 7. From this example we can say that no loss has been incurred since a 1 point loss was incurred on a portion of a transaction and a 1 point gain was incurred on the remainder of the transaction, the loss and the gain off-setting each other. This result, to our mind, is the only practical manner in which the words of the constitution and the words of the legislature can be given any meaning. It would be an impossible task to establish the test of loss on a security by security basis or even on a purchase by purchase basis.

We conclude, therefore, that any loss within the constitutional meaning must be tested by the entire transaction as a whole, notwithstanding the fact that different types of interest bearing securities are sold in the same transaction and that these securities may have different maturity dates.

Opinion No. 68-116 took the position that there was an interrelationship in applying the 1965 amendment to the remainder of Article XII, Section 7. After in-depth examination and study we do not believe that to be the case. The 1965 amendment can stand alone and be fully operative in the situations it contemplates, e.g., sale of bonds at a loss and subsequent purchase of **bonds** at a price and yield which will offset the loss over the life of the new investment. In some respects the amendment is restrictive, and in other respects it liberalizes what is to be considered a "constitutional loss." The Council cannot, for instance sell bonds (or other fixed income type securities) at a loss and purchase with the proceeds other bonds are fixed income type securities which will not increase the interest income in an amount sufficient to restore the corpus of the fund over the life of the new investment. On the other hand, prior to the 1965 amendment the Council could not have sold these fixed income type securities at a loss and subsequently purchased the same type of securities to make up the loss. Upon the sale at a loss there would have been a loss in the constitutional sense which could not have been offset by any later purchase. For these reasons we conclude that the last sentence of Opinion No. 68-116 was erroneous.

The **simultaneous** transaction which you describe in your examples is still legally permissible. Since it is not the type of transaction contemplated by the 1965 amendment, that provision does not preclude such a sale and purchase.

By: Oliver E. Payne

Deputy Attorney General