

STATE OF MINNESOTA
DEPARTMENT OF REVENUE
INCOME TAX DIVISION

IN THE MATTER OF THE PROPOSED ADOPTION
OF A NEW RULE OF THE DEPARTMENT OF
REVENUE RELATING TO SUBTRACTION FOR
INTEREST ON UNITED STATES GOVERNMENT
OBLIGATIONS.
(13 MCAR SECTION 1.6007)

STATEMENT OF NEED
AND REASONABLENESS

This document has been prepared as a verbatim presentation of the facts necessary to establish the statutory authority, need for and reasonableness of the proposed new rule. It is submitted pursuant to 9 MCAR Section 2.104 requiring a Statement of Need and Reasonableness.

A Notice of Intent to Solicit Outside Opinion regarding the proposed rule was published in the State Register on January 29, 1979, and July 6, 1981. The proposed rule was submitted for comment to those people and organizations that requested it, to the members of the Commissioner's Advisory Committee, and to various legislative legislative staff persons. Suggestions and comments that were received have been duly considered.

Authority to Adopt the Rule

Minn. Stat. Section 290.52 grants the Commissioner statutory authority to establish rules concerning the income tax.

Statement of Need

Minn. Stat. Section 290.01, Subd. 20(b)(1), allows a subtraction from federal adjusted gross income of interest earned on obligations of the United States to the extent includable in gross income for

federal income tax purposes provided the interest is exempt from state income tax under federal law. The general federal law, 31 U.S.C. § 742, provides that all stocks, bonds, Treasury notes and other obligations of the United States, shall be exempt from taxation by state and local authorities, including interest earned thereon. Neither the federal or state statute defines which obligations are obligations of the United States, and neither statute provides guidelines for making this determination. Some federal statutes, such as 12 U.S.C. § 1433 Federal Home Loan Banks, specifically state that principal and interest of all notes, debentures, bonds and other obligations are exempt from taxation by state or local authority. Other enabling acts contain no specific exemption for interest earned, for example, 12 U.S.C. § 1723a(c)(1) exempts the assets of the National Mortgage Association from taxation, but a specific exemption from state taxation of income earned on the Association's obligations is not contained in the National Housing Act. Since the statutes are not always clear as to the taxable status of the obligations, a rule is necessary to define the circumstances under which interest income will be exempt from state income tax and qualify for the subtraction.

A survey of the treatment of United States obligations by the various states shows that the states are not uniform in application of exempt or taxable status. For example, Nebraska exempts obligations of the Federal Reserve Bank and the Metropolitan Area Transit Authority from state taxation while North Dakota and New Jersey do not. Pennsylvania and North Dakota exempt interest from obligations of the Export-Import Bank of the United States;

however, New Jersey does not allow an exemption for participation certificates issued by the Export-Import Bank. Many states have regulations or a listing of obligations that are considered exempt in that state. The different treatment is reflected in these listings. Listings by the states cited above are attached as appendixes at the end of this statement. In order to avoid confusion for the taxpayer, it is necessary for the state of Minnesota to provide an official guideline defining the taxable status of the obligations in this state.

The rule is proposed to aid the department and the taxpayer in determining which United States obligations qualify for the subtraction. The rule sets out specific criteria that the obligation must meet in order to qualify for the subtraction and provides exhibits the taxpayer may refer to in deciding if the obligation meets the criteria. Both the department and the taxpayer will benefit from a clear and concise rule regarding this subtraction.

Statement of Reasonableness

The proposed rule is based on the Minnesota and Federal statutes and court decisions regarding the exemption from state taxation of United States obligations. Sections A and B of the proposed rule follow the requirements of Minn. Stat. § 290.01, subd. 20 (b)(1) that the income must have been included in federal adjusted gross income and be earned from an obligation of the United States before it can be subtracted. Section B also helps to define which obligations are obligations of the United States under 31 U.S.C. § 742.

The United States Supreme Court in Smith v. Davis, 323 U.S. 111, 65 S.Ct. 157, 89 L. Ed. 107 (1944), stated that obligations

constitutionally exempt from state and local taxation must be characterized by:

- (1) written documents, (2) the bearing of interest,
- (3) a binding promise by the United States to pay specific sums at specified dates and (4) specific Congressional authorization, which also pledged the full faith and credit of the United States in support of the promise to pay. 323 U.S. 115.

The Court in Smith v. Davis, id., also found that an open account or unsettled claim or demand cannot meet the above criteria, and are not instruments of the United States for purposes of tax immunity.

Section C of the proposed rule incorporates the standards of Smith v. Davis and provides a check list that the department and taxpayer can compare with a particular obligation to determine if the standards are met.

Section D of the proposed rule reflects the decision of the Minnesota Tax Court of Appeals in Tobak v Commissioner, D. No. 2244 Minn. Tax Court (March 10, 1977). The Court concluded that interest payments on promissory notes that were originally private obligations were exempt from state taxation, because the payments were secured by the full faith and credit of the United States and the holder would receive payment only from the United States. In reaching this conclusion, the Court noted that the notes contained an insurance endorsement that (1) was secured by the full faith and credit of the United States, (2) provided for

interest payments directly from the United States Treasury, and (3) the holder agreed to forego all rights and remedies against the maker of the note.

The obligation in Tobak v. Commissioner was found to be a primary obligation of the United States not because of the insurance endorsement, but because the holder had relinquished all rights against the original maker. If the holder had not foregone these rights, the United States would have been obligated only if the maker failed to make the payments. The interest payments would not have been an obligation of the United States under 31 U.S.C. § 742, and would not be exempt from state taxation.

The proposed rule includes four exhibits, Section E, Exhibits I through IV. These exhibits are tables that list securities that may or may not be exempt from Minnesota income tax. The tables include citations to authorities that indicate the taxable status of the security. The exhibits are included as a quick reference or a guideline for the convenience of the taxpayer and the department. The exhibits are not conclusive in themselves and the taxable status of an obligation must be determined by the requirements of sections A through D of the proposed rule.

The exhibits were prepared from an examination of the federal statutes, classification by other states and case authority. Most of the securities in Exhibit I and the agencies in Exhibit III are specifically exempted from state taxation by federal law, an example is Rental Housing Insurance issued by the Department of Housing and Urban Development, 12 U.S.C. § 1713(i) states that such debentures

shall be exempt, both as to principal and interest from all taxation by any state. The securities in Exhibit II and the organizations in Exhibit IV do not have specific exemptions by federal law, and do not qualify for the exemption under Sections A through D of the proposed rule. Where other states classifications conflicted with the exhibits, the department followed the criteria specified in Smith v. Davis and Tobak v. Commissioner in making its classification. In all instances, the department made an independent determination of taxable status according to the requirements of the proposed rule.

the category of income subject to tax defined as net gains or income from disposition of property shall not include within such category obligations issued by or on behalf of this State or any county, municipality, school or other district, agency, authority, etc., of this State or obligations which are statutorily free from State or local taxation under any other act of this State or under the laws of the United States.

The law further provides that losses can only be applied against other sources of gross income within the same category of gross income during the taxable year.

Therefore, losses which occur on obligations not included for gross income tax purposes can not be applied against the net gains or income realized on obligations which come within a category of income subject to tax. *State Tax News*, July/August, 1978.

.90 U. S. Treasury bills.—Under the provisions of the New Jersey Gross Income Tax Act, the income of a New Jersey resident as a beneficiary of an estate or trust retains the same character as in the hands of the estate or trust.

The New Jersey Gross Income Tax Act at N. J. S. A. 54A:6-14 exempts from the tax, interest on obligations of the State of New Jersey, its agencies, instrumentalities or political subdivisions thereof and also the interest on federal obligations which are statutorily free from State or local taxation under any other act of this State or under the laws of the United States.

Accordingly, interest on U. S. Treasury bills received by such beneficiary from an estate or trust would not be subject to the New Jersey gross income tax. *State Tax News*, July/August, 1981.

[§ 15-566] Reg. 18:35-1.9 Taxable Status of Federal Securities.—(a)

Gross income shall not include interest on obligations:

1. Issued by or on behalf of New Jersey or any county, municipality, school or other district, agency, authority, commission, instrumentality, public corporation (including one created or existing pursuant to agreement or compact with this or any other state), body corporate and politic or political subdivision of New Jersey; or

2. Those obligations which are statutorily free from State or local taxation under any act of New Jersey or under the laws of the United States.

(b) The term "net gains or income" shall not include gains or income derived from obligations whose interest is exempt from tax under paragraph 1. of this subsection. Losses from sales of such exempt securities shall not be taken into account in the computation of gains from disposition of property. A list of various securities follows, together with an indication of whether the interest and the gains there from are taxable or exempt:

1. Federal securities:

	Security	Interest
i.	Asian Development Bank	T
ii.	Bank for Cooperatives	E
iii.	Environmental Financing Authority	T
iv.	Export-Import Bank of the United States ("Eximbank"):	
	(1) Series 1978—B debentures	E
	(2) Participation certificates (reversal of Counsel opinion dated 8/29/67)	T
v.	Federal Deposit Insurance Corporation obligations	E
vi.	Federal Housing Authority (F.H.A.)	E
vii.	Farmers Home Administration	E
viii.	Federal Financing Bank	E

1. Federal securities:

	Security	Interest
ix.	Federal Home Loan Bank	E
x.	Federal Home Loan Mortgage Corp.	T
xi.	Federal Intermediate Credit Banks	E
xii.	Federal Land Banks	E
xiii.	Federal National Mortgage Association (Fannie Mae):	
	(1) Interest on bonds and debentures	T
	(2) Guaranteed Participation Certificates	T
xiv.	Federal Savings and Loan Insurance Corporation obligations	E
xv.	General Services Administration	E
xvi.	Government National Mortgage Assn. (Ginnie Mae)	T

¶ 15-566

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1. Federal securities:			1. Federal securities:		
	Security	Interest		Security	Interest
xvii.	Guam	E	xxv.	Production Credit Associations	E
xviii.	H.U.D./New Communities	E	xxvi.	Puerto Rico Water Resources—4.2 per cent bonds due 1/1/89—	
xix.	H.U.D. Public Housing Notes and Bonds (Taxfree in State of issuance.)			Interest on Bonds	E
	(In state of issuance)	E	xxvii.	Puerto Rico	E
	(1) If issued in the District of Columbia, Puerto Rico, the Virgin Islands, they are exempt from all State tax.)		xxviii.	R.F.K. Stadium Bonds	T
	(If issued in other states)	T	xxix.	Small Business Administration	E
xx.	Inter-American Development Bank Bonds	T	xxx.	Student Loan Marketing Association	E
xxi.	International Monetary Fund and Bank for Reconstruction and Development (World Bank)	T	xxxi.	Tennessee Valley Authority	E
xxii.	Jonathan Development Corp. (Obligations guaranteed under New Communities Act of 1968)	T	xxxii.	U.S. Postal Service	E
xxiii.	Merchant Marine	E	xxxiii.	U.S. Treasury	E
xxiv.	Panama Canal Zone Bonds specifically exempt from tax by 31 USC 744 and 745	E	xxxiv.	U.S. Treasury Bills	E
			xxxv.	USAVE Certificates—Farmers Home Administration Insured Loan Notes	Partially
			xxxvi.	Virgin Islands	E
			xxxvii.	Washington Metropolitan Area Transit Authority Bonds	T

(Adopted August 15, 1978.)

[¶ 15-570] Other Retirement Income.—The law provides:

Sec. 54A:6-15. ***

a. Gross income shall not include income of up to \$10,000.00 for a married couple filing jointly, \$5,000.00 for a married person filing separately or \$7,500.00 for a single taxpayer, when received in any tax year by a person aged 62 years or older who received no income in excess of \$3,000.00 from one or more of the sources enumerated in subsections a., b. and k. of N. J. S. 54A:5-1, provided, however, that the total exclusion under this subsection and that allowable under N. J. S. 54A:6-10 shall not exceed the amounts of the exclusions set forth in this subsection.

b. In addition to the exclusion provided under N. J. S. 54A:6-10 and subsection a. of this section, gross income shall not include income of up to \$6,000.00 for a married couple filing jointly or \$3,000.00 for a single person or a married person filing separately who is not covered under N. J. S. 54A:6-2 or N. J. S. 54A:6-3, but who would be eligible in any year to receive payments under either section if he or she were covered thereby. [R. S. 54A:6-15.]

[Editorial Comment:] The exclusion offered under Sec. 54A:6-15(a) is granted to persons 62 years of age or older who receive no earned income in excess of \$3,000 from remuneration, net profits from business or a distributive share of partnership income, see ¶ 15-405, 15-410 and 15-455.

If a person claims the exclusion offered under Sec. 54A:6-15(a) for persons 62 years of age or older who receive limited earned income and the pension and annuity income exclusion offered under Sec. 54:6-10, he may not claim more than the maximum exclusion offered under Sec. 54A:6-15(a).

Persons not covered by the Federal Social Security Act or the Railroad Retirement Act, but who would otherwise be covered may exclude up to

→ Indexed by the Cumulative Indexes (last pages of compilation divisions).
Kerr and Koper v. The City of Erie

[¶ 201-422] James W. Kerr and Dennis J. Koper v. The City of Erie.

Court of Common Pleas, Erie County, September 29, 1981, No. 1458 A-1981.

Cities—Special Tax Powers—Jurisdictions Other than Philadelphia—Failure to Properly Advertise Tax Increase.—The failure of the City of Erie to properly advertise an ordinance increasing the rate of its earned income tax from 1% to 1½% rendered the ordinance invalid. The city advertised its intention to increase the tax only once. The Local Tax Enabling Act requires that, prior to the passage of an ordinance imposing a tax or license fee, notice of intention to pass such an ordinance must be published once a week for three weeks in a newspaper of general circulation. The attempt to increase the tax rate necessitated the reenactment of the ordinance enacting the tax, and the notice provisions relating to the passage of an ordinance imposing a tax should have been followed. Accordingly, the ordinance increasing the tax from 1% to 1½% was invalidated. Sec. 14, Act of December 31, 1965, P. L. 1257 (53 P. S. Sec. 6904).

See ¶ 100-150.

[¶ 201-423] Letter of Deputy Secretary for Taxation of Department of Revenue.

To Commerce Clearing House, Inc., February 19, 1982.

Personal Income—Exclusions and Exemptions.—Gains or Income from Exempt Obligations.—The following is a letter from the Deputy Secretary for Taxation of the Department of Revenue containing an updated listing of obligations of the United States for which the interest and gains from sale are exempt from Pennsylvania personal income tax.

See ¶ 15-510.

Below is a list of agencies, instrumentalities or territories of the federal government. The interest income as well as the gain from the disposition of obligations issued by these agencies is exempt from tax. Of course, interest or gain from direct United States obligations such as Series E, F, G, and H bonds, treasury bills or notes is also exempt from tax.

The interest or gain from obligations issued by the Commonwealth of Pennsylvania or its political subdivisions is exempt from tax under the Act of 1971, August 31, P. L. 395 No. 94 § 2, 72 P. S. § 4752-2. Interest or gain from obligations issued by other states or their political subdivisions is subject to tax.

Obligations of Federal Agencies, Instrumentalities or Territories Exempt from Taxation on Gain or Interest under the Pennsylvania Personal Income Tax Act:

Banks of Cooperatives
Central Bank for Cooperatives
Commodity Credit Corporation
Export—Import Bank of the United States
Farm Credit Bank
Farmers Home Corporation
Federal Deposit Insurance Corporation
Federal Farm Loan Corporation
Federal Financing Bank
Federal Home Loan Banks
Federal Housing Administration
Federal Intermediate Credit Banks
Federal Intermediate Credit Corporation
Federal Land Banks
Federal Land Bank Associations
Federal Savings and Loan Insurance Corporation

¶ 201-422

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General Insurance Fund—Interest derived from debentures issued under the War Housing Insurance Law or from Armed Services Housing Mortgages debentures or from debentures used to acquire housing projects.

General Service Administration

Government of Guam

Government of Puerto Rico

Government of the Virgin Islands

Home Owners Loan Corporation

Joint Stock Land Banks

Maritime Administration

Panama Canal Bonds—Specifically exempted from tax by 31 U. S. C. § 744 and § 745.

Production Credit Associations

Small Business Administration

Tennessee Valley Authority

United States Housing Authority

United Maritime Commission

United States Postal Service

[§ 201-424] Reg. Secs. 31.41—31.50.

Amended January 31, 1981.

Sales and Use—Sales of Vehicles.—Following is the full text of the sales and use tax regulations related to motor vehicles.

See § 64-157.

§31.41. Definitions.

The following words and terms, when used in these §§ 31.41 — 31.50 shall have the following meanings, unless the context clearly indicates otherwise:

Fair rental value — The amount which would be charged for the rental of a vehicle in the open market for a similar period of time and place. When the actual fair rental value is unknown, the Department will recognize 3.0% of the purchase price as a monthly fair rental value of a vehicle provided such purchase price is the fair market value of such vehicle.

Motor vehicle — A vehicle which is self-propelled except one which is propelled solely by human power or by electric power obtained from overhead trolley wires but not operated upon rails.

Prevailing market price — The price which the vehicle will bring if offered for sale in the open market at the time and place of the taxable transfer or use of the vehicle.

Purchase price — The total value of anything paid or delivered or promised to be paid or delivered, whether in money or otherwise, including any encumbrance or other obligation assumed by the transferee.

northeast corner of section 24. Then $14\frac{3}{4}$ miles to the southeast corner of township 31 north, range 4 west, section 36.

The Omaha Reservation is located primarily in the southern half of Thurston County with a few sections in adjacent Burt County and Cuming County all in northeastern Nebraska. It can be described approximately as follows:

From the point at which Wood Creek enters the Missouri River at township 24 north, range 10 east, section 36, go due west $30\frac{1}{2}$ miles to township 24 north, range 5 east to a point in the northeast corner of section 34. Then north $5\frac{1}{4}$ miles to township 24 north, range 5 east, northwest corner of section 2. Then east $\frac{1}{8}$ mile. Then due north 5 miles to township 25 north, range 5 east, northeast corner of section 10. Then due east $13\frac{3}{4}$ miles to township 25 north, range 7 east, northeast corner of section 12. Then 2 miles due north to township 26 north, range 7 east, northeast corner of section 36. Then due east to the Iowa border then south along the border to Wood Creek.

The Winnebago Reservation is located primarily in the northern half of Thurston County with a few sections in adjoining Dixon County and entirely in northeastern Nebraska. It is described approximately as follows:

From the point the Iowa border meets the southeast corner of lot 4, section 25, township 26 north, range 9 east, go due west $9\frac{1}{4}$ miles to township 26 north, range 7 east, northeast corner of section 25. Then due south 2 miles to township 25 north, range 7 east, northeast corner of section 12. Then west $13\frac{3}{4}$ miles to township 25 north, range 5 east, northeast corner of section 10 then north $8\frac{1}{8}$ miles to township 27 north, range 5 east, northwest corner of section 35. Then due east to the Iowa-Nebraska border. Then south along the border to the beginning point.

The cities, towns, and villages of Pender, Thurston, Winnebago, Macy, Walthill, Rosalie, Santee, and Lindy are located within the boundaries of the three Nebraska Indian reservations. The City of Emerson, south of First Street, is also within the reservation.

[¶ 15-014] Department of Revenue Ruling No. 21-77-1, Approved July 22, 1977.

Withholding—Retention of Magnetic Tape Containing W-2 Information.—A TAXPAYER WHO HAS PROVIDED THE DEPARTMENT OF REVENUE WITH MAGNETIC TAPES CONTAINING FORM W-2 INFORMATION MUST RETAIN EITHER THE TAPES OR SUPPORTING DOCUMENTATION FOR THE STATUTORY PERIOD.

Advice has been requested concerning the period of time a taxpayer must retain the magnetic tape containing W-2 information provided the Department of Revenue in lieu of providing paper copies of the W-2 information.

There is no specific requirement for retention of the magnetic tapes containing W-2 information if supporting documentation is available for the statutory period. The statutory period is three years after the date the taxes to which the W-2's are related are due or the date the taxes are paid, whichever is later.

The Department of Revenue makes a copy of the magnetic tape and returns the original to the taxpayer. The magnetic tape must be retained by the taxpayer for the statutory period if supporting documents are not available.

[¶ 15-015] Department of Revenue Ruling No. 22-77-1, Approved December 30, 1977.

Individual Income Tax—Deduction of Income from United States Government Obligations.—ALLOWABLE DEDUCTIONS FROM FEDERAL TAXABLE INCOME FOR NEBRASKA INDIVIDUAL INCOME TAX PURPOSES ARE ONLY THOSE ITEMS EXEMPT FROM STATE TAXATION UNDER THE LAWS OF THE UNITED STATES.

Advice has been requested whether interest or dividend income from United States government obligations are deductible for Nebraska individual income tax purposes.

Nebraska law provides that interest or dividends on obligations of the United States and its territories and possessions or of any United States authority, commission, or instrumentality, if included in federal gross income but exempt from state income taxation under the laws of the U.S., shall be subtracted from federal taxable income. Section 77-2716(1), R.R.S. 1943.

Interest or dividend income from the following sources is deductible for Nebraska individual income tax purposes:

1. United States government bonds, such as Series E, F, G, and H;
2. United States Treasury bills;

3. United States government notes;
4. United States government certificates;
5. Federal Land Banks;
6. Commodity Credit Corporation;
7. Federal Home Loan Banks;
8. Federal Intermediate Credit Banks;
9. Federal Reserve Bank;
10. Federal Savings and Loan Insurance Corporation;
11. Tennessee Valley Authority bonds;
12. Railroad supplemental retirement annuities;
13. Metropolitan Area Transit Authority bonds;
14. Export-Import Bank bonds;
15. Interest on debentures issued to mortgagees of mortgages foreclosed under provisions of the National Housing Act insured after February 3, 1938.

Interest but not dividend income is deductible for Nebraska individual income tax purposes from the following sources:

1. Federal Deposit Insurance Corporation;
2. Central Bank for Cooperatives and Banks for Cooperatives;
3. Production Credit Associations.

Interest or dividend income received from the following sources is taxable and cannot be deducted from federal taxable income for Nebraska individual income tax purposes:

1. Federal or State Savings and Loan Associations;
2. Building and Loan Associations;
3. Postal Savings Accounts (discontinued in 1966);
4. Federal or State Credit Unions;
5. Mortgage Participation Certificates issued by the Federal National Mortgage Association;
6. Interest on federal income tax refunds;
7. Interest on debentures issued to mortgagees of mortgages foreclosed under the provisions of the National Housing Act if insured prior to February 3, 1938;
8. Federal National Mortgage Associations (FNMA).

The following types of income are not includible in federal taxable income and thus cannot be deducted from federal taxable income for Nebraska individual income tax purposes:

1. Social Security income;
2. Interest income from municipal bonds;
3. Various exempt retirement plans;
4. Puerto Rico Bonds;
5. Virgin Island Bonds.

The items that are allowable deductions from federal taxable income for Nebraska individual income tax purposes are only those items includible in gross income for federal income tax purposes but exempt from state income tax under the laws of the United States.

Any interest or dividend received from the following sources is exempt and should be deducted on state return.

SOURCE

Banks for Cooperatives	12 USC 2134
Central Bank for Cooperatives	12 USC 2134
Commodity Credit Corporation	15 USC 713a-5
Export - Import Bank	12 USC 635
Farmers Home Administration Notes	7 USC 1938b
Federal Deposit Insurance Corporation	12 USC 1825
Federal Farm Loan Corporation	12 USC 1020 (discontinue
Federal Financing Bank	12 USC 2288
Federal Home Loan Banks	12 USC 1433
Federal Housing Administration	12 USC 1713
Federal Intermediate Credit Banks	12 USC 2079
Federal Land Banks	12 USC 2055
Federal Saving & Loan Insurance Corporations	12 USC 1725
Joint Stock Land Banks	12 USC 2055
National Farm Loan Association	12 USC 2055
Panama Canal Bonds	31 USC 744
Postal Saving System	39 USC 5205 (discontinue
Production Credit Associations	12 USC 2098
Production Credit Corporations	12 USC 2098
Puerto Rico Bonds	48 USC 745
Public Housing Agencies	42 USC 1437i
Tennessee Valley Authority	16 USC 831n-4d
United States Maritime Commission	46 USC 1275

Any interest or dividends received from the following sources is not exempt:

1. Federal or state savings and loan associations, 12 USC 1464;
2. Federal National Mortgage Association, 12 USC 1721b;
3. Government National Mortgage Association, 12 USC 1721b;
4. Building and loan associations

Interest received in the following instances is not exempt:

1. On refunds of federal income tax;
2. On interest bearing certificates issued in lieu of tax exempt securities, such income losing its identity when merged with other funds;
3. On debentures issued to mortgagees of mortgages foreclosed under the provisions of the National Housing Act;
4. On promissory notes of a federal instrumentality; and
5. Washington Metropolitan Area Transit Authority, 12 USC 24;
6. On refunds of state income tax.