

Taxation of Dividends Paid by
Regulated Investment Companies

A question has been raised with respect to the New York State taxation of dividends paid by regulated investment companies (mutual funds) that have invested directly in tax-exempt U.S. obligations. The following which is printed in its entirety is an Opinion of Counsel dealing with this question.

OPINION OF COUNSEL

Taxation of Dividends Paid by Regulated Investment
Companies Which Are Attributable to Federal Obligations

A question has arisen, in light of two recent United States Supreme Court decisions, as to the propriety of the imposition of New York's Personal Income Tax on dividends paid by regulated investment companies ("mutual funds") which are derived from interest on Federal obligations.

In Memphis Bank & Trust Co. v Garner, US , 74 L Ed 2d 562 (1983) and American Bank & Trust Co. v Dallas County,

US , 77 L Ed 2d 1072 (1983), the Supreme Court reexamined the scope of the exemption from state taxation applicable to Federal obligations which, at the time, was provided in Rev. Stat. 3701, 31 USC § 742, as amended in 1959 by Pub. L. 86-346, § 105(a). Section 3701, in the form construed by the Court, read as follows:

"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. This 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, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes."

Title 31 of the United States Code was enacted into positive law in 1982, and 31 USC § 742 was replaced by 31 USC § 3124(a). Former section 3701, as so enacted, was amended for purposes of "clarity", but was "intended to remain substantively unchanged." H.R. Rep. No. 97-651, 97th Cong., 2d Sess. 3, 94, (1982 US Code, Cong. & Ad. News 1988); American Bank and Trust Co. v Dallas County, supra, at note 1.

In Memphis Bank and Trust Co. v Garner, supra, the Supreme Court stated that section 3701 "establishes a broad exemption of federal obligations from state and local taxation." The Court went on to strike down as discriminatory a Tennessee bank tax imposed on the net earnings of banks doing business within the State and which defined net earnings to include income from obligations of the United States and its instrumentalities, but which excluded therefrom interest earned on obligations of the State of Tennessee and its political subdivisions. The Court grounded its conclusion on the principle that a "state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations." Id., at 567-8. it should be noted that this case is not,

strictly speaking, applicable to the matter at hand, because the taxpayers subject to the New York Personal Income Tax are not "holders of federal property" but, rather, holders of corporate stock.

In American Bank and Trust Co. v Dallas County, supra, the Supreme Court invalidated a State property tax on bank shares which was determined on the basis of the bank's net assets without any deduction for tax-exempt United States obligations. The Court, in ruling that the plain language of section 3701 (with specific exceptions) barred all state taxation, regardless of its form, if federal obligations must be considered in computing the tax, stated that:

"the [1959] amendment [to section 3701] abolished the formalistic inquiry whether the tax is on a distinct interest, and replaced it with the inquiry whether 'computation of the tax' requires consideration of federal obligations."

That is, what the amendment sought to invalidate was a tax imposed on one entity but measured by the value, income or other characteristic of another entity, including Federal obligations. The decision itself dealt, thus, with a tax on one entity (bank shares) measured, in part, by the value of the bank's net assets, including the value of Federal obligations.

The instant question is whether in light of the Memphis Bank and American Bank cases the New York Personal Income Tax may be imposed on dividends paid by mutual funds which are attributable to interest on Federal obligations. Representatives of certain mutual funds assert that the Memphis Bank and American Bank cases stand for the proposition that such an imposition would amount to a tax which indirectly includes Federal obligations, or interest

thereon, in the computation of the tax in violation of Rev. Stat. section 3701.

In conformity with the exemption for Federal obligations contained in Rev. Stat. section 3701, the New York Tax Law contains specific exemptions from the New York Personal Income Tax for interest on obligations of the United States or of its agencies or instrumentalities. (Tax Law, § 612(c) (1) and (2)).

However, a dividend paid by a corporation to a shareholder does not have the same characteristic as the funds from which such dividend is paid. In general, a corporation is a nonconductor that cuts off connection between dividends to its stockholders and the corporate funds from which the dividends are paid. (Miller v City of Milwaukee, 272 US 713, 714). The nature of the corporate funds from which dividends are paid does not flow through when paid to the shareholders. If such corporate funds are tax-exempt, the dividends paid derived from such funds are, nevertheless, taxable to the shareholders. Corporations which receive tax-exempt interest on governmental obligations are not conduits which can pass the tax-exemption along when paying dividends derived from tax-exempt interest. See Treasury Reg. § 1.312-6(b) , which provides that "Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends." An exception exists with respect to certain mutual fund dividends derived from income from municipal obligations, but it is significant that Congress

found it necessary to enact section 852(b) (5) of the Internal Revenue Code in order to enable mutual funds to pay such "exempt-interest dividends". The legislative history of the Tax Reform Act of 1976, which enacted section 852(b) (5) of the Code, bears this out, stating that: ". . . there is presently no flow-through treatment for tax-exempt interest and, consequently, distributions of tax-exempt interest by a regulated investment company are taxable income to its shareholders." (House Conference Report No. 94-1515; 1976 US Code, Cong. & Ad. News 4240) It should be noted that the situation with respect to shareholders of a corporation is different from that obtaining with respect to certificate holders in unit investment trusts. Where these latter possess beneficial interests in the corpus of the trust, the interest income of the trust retains its character in their hands, and is taxed accordingly. Cf. Carson Estate Co., 31 B.T.A. 607, aff'd 80 F2d 1007; Bess Schoellkopf, 32 B.T.A. 88.

It is my opinion that a dividend paid by a corporation to a shareholder who is a resident of New York State is subject to the State's income tax regardless of the fact that such dividend may have been derived from interest on a Federal obligation or from an obligation of New York State. An opinion dated February 5, 1980 was issued by this Department's Counsel, to the effect that dividends paid by mutual funds which are derived from interest on Federal obligations are subject to the State's income tax, even if the mutual fund also pays exempt-interest dividends

derived from New York State obligations, which dividends are exempt from Federal income tax and are not subject to New York State's income tax. (TSB-M-79-(14)-I) Previously, this Department had held that exempt-interest dividends paid by mutual funds which are derived from interest on the obligations of other states are subject to New York's Personal Income Tax. I hereby reaffirm those opinions.

Under section 852(b) (5) (B) of the Internal Revenue Code, an exempt-interest dividend is characterized as interest on a state or municipal obligation which is excludible from Federal gross income pursuant to section 103(a) of the Code. Since terms used in New York's Personal Income Tax are given the same meaning as when used in a comparable context in the Internal Revenue Code (Tax Law, § 607), exempt-interest dividends are treated as "interest" on state or municipal obligations for purposes of the State's income tax, for the sole reason that they are so characterized under the Federal statute. Under the New York Personal Income Tax, interest on obligations of other states or of their political subdivisions must be added to Federal adjusted gross income in computing New York adjusted gross income. (Tax Law, § 612(b) (1)) There is no similar modification which would add to Federal adjusted gross income interest on obligations of New York State or of its political subdivisions. Hence, exempt-interest dividends which are derived from interest on obligations of other states are subject to New York's Personal Income Tax, while exempt-interest dividends derived from New York obligations are not subject to the tax.

Some mutual funds which pay exempt-interest dividends also pay dividends derived from interest on Federal obligations. However, since such interest is not excludible income under section 103(a) of the Internal Revenue Code, such interest is not includable in the computation of the amount of exempt-interest dividends payable by such mutual funds. (IRC § 852(b) (5)) Hence, dividends paid by such mutual funds which are derived from interest on Federal obligations are not given any particular statutory treatment for purposes of the Federal income tax and are, therefore, not given any particular statutory treatment for purposes of the New York law. Ordinarily, therefore, these dividends are subject to tax under the Internal Revenue Code and the New York Personal Income Tax in the same manner as any dividend received.

The foregoing analysis, which excludes from computation of the New York income tax exempt-interest dividends which are derived from interest on New York obligations, but which states that dividends derived from interest on Federal obligations are to be included in such computation, may appear to constitute a discriminatory application of the New York Personal Income Tax. In my opinion, it is not.

First, the New York Personal Income Tax is not imposed on Federal obligations or interest thereon. Interest on Federal obligations is specifically excluded from the computation of the tax. (Tax Law, § 612(c) (1) and (2)) However, the tax is imposed upon all corporate dividends received by a resident of New York, which may or may not be derived from Federal

obligations or interest thereon. ("Exempt-interest dividends" are, on a statutory basis, treated not as dividends but as interest.) As previously stated, a dividend does not retain the nature of the funds from which it was derived.

Second, if any discrimination against Federal obligations may be said to occur, it is solely by reason of the enactment of Federal law (IRC § 852(b) (5)), rather than the enactment of any discriminatory law by the State. "A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them." Miller v Milwaukee, 272 US 713, 715; Macallen Co. v Massachusetts, 279 US 620, 631; Educational Films Corp. v Ward, 282 US 379, 393. Since it is the operation of the Federal law relating to exempt-interest dividends which characterizes exempt-interest dividends as interest, thereby excluding those exempt-interest dividends derived from New York obligations from the New York income tax, it cannot be said that any law of New York was enacted with the intent to discriminate against corporate dividends derived from Federal obligations.

Furthermore, the imposition of the New York Personal Income Tax on dividends derived from interest on Federal obligations is not the imposition of a tax which requires Federal obligations, or interest thereon, to be considered, even indirectly, in the computation of the tax. The American Bank case makes it clear that such a tax is prohibited by Rev. Stat. section 3701.

In that case, a state bank shares tax was computed by determining the amount of the bank's capital assets, including Federal obligations, subtracting therefrom the bank's liabilities and the assessed value of the bank's real estate, and dividing the result by the number of shares. The Court held that such a tax takes into account, "at least indirectly", the Federal obligations owned by the bank. That tax, which included the value of the actual obligations in the computation of the tax, is plainly distinguishable from the New York income tax, which taxes dividends derived from Federal obligations but does not include the actual obligations, or interest thereon, in the computation of the tax. That is, unlike the tax in American Bank, the New York tax is not imposed on one entity but measured by, or computed based upon a consideration of, any feature of Federal obligations. Rather, it is a tax imposed directly on, inter alia, dividends, and in no way is measured by any entity other than such dividends. Accordingly, such tax, insofar as it affects dividends derived from income on Federal obligations, runs afoul of neither the Federal statutory nor Constitutional bars applied in the Memphis Bank and American Bank cases. Ultimately, of course, the proper forum for the resolution of any such constitutional issue would be the courts.

s/John P. Dugan
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