

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-91 (9) I
Income Tax
December 5, 1991

STATE OF NEW YORK

COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. I910702A

On July 2, 1991, a Petition for Advisory Opinion was received from Federal Trust Fund, Bellevue Park Corporate Center, 103 Bellevue Parkway, Suite 152, Wilmington, Delaware 19809.

The issues raised by Petitioner, Federal Trust Fund, are whether Petitioner and its shareholders are allowed to treat Petitioner's "Exempt Obligations" as "obligations of the United States" for purposes of section 612(c)(1) of the Tax Law and provided that the relevant asset and notice requirements are satisfied, whether the shareholders are allowed to treat dividends paid by the Petitioner that are attributable to interest paid on such "Exempt Obligations" as a subtraction item for purposes of section 612(c)(1) of the Tax Law.

Petitioner is one of seven separate portfolios of the Trust For Federal Securities which is a Pennsylvania business trust. Petitioner and each of the other six portfolios are separate regulated investment companies (hereinafter "RICs") for federal and New York State tax purposes. For purposes of this petition, an obligation is denominated by Petitioner as an "Exempt Obligation" if (a) it is described in TSB-M-86(8)I, (b) it is an obligation of the federal government or of the federal government's agencies, authorities and instrumentalities, (c) interest on the obligation is subject to federal income taxation, and (d) interest on the obligation is exempt from New York State income taxation under Article 22 of the Tax Law.

Section 612(c) of the Tax Law, as amended by Chapter 535 of the Laws of 1986, provides, in part:

There shall be subtracted from federal adjusted gross income:

(1) Interest income on obligations of the United States and its possessions to the extent includible in gross income for federal income tax purposes; such interest income shall include the amount received as dividends from a regulated investment company, as defined in section eight hundred fifty-one of the internal revenue code, which has been designated as the amount of such interest income in a written notice to shareholders not later than forty-five days following the close of its taxable year; provided that, at the close of each quarter of the taxable year of such regulated investment company, at least fifty percent of the value of its total assets, as defined in subsection (c) of section eight hundred fifty-one of the internal revenue code, consists of obligations of the United States and its possessions.

(2) Interest or dividend income on obligation or securities of any authority, commission or instrumentality of the United States to the

extent includible in gross income for federal income tax purposes but exempt from state income taxes under the laws of the United States . . .

Section 612(c)(1) of the Tax Law provides that dividends paid by qualifying RICs that are attributable to interest on "obligations of the United States" (hereinafter "tax-exempt dividends") are not subject to New York State income taxation if the relevant asset and notice requirements are satisfied (*i.e.*, a shareholder of a RIC can treat his tax-exempt dividends as a subtraction item for purposes of section 612(c)(1) of the Tax Law). Although the phrase "obligations of the United States" is not defined in section 612(c)(1) of the Tax Law, the legislative history of section 612(c)(1) of the Tax Law indicates that dividends can qualify as tax-exempt dividends so long as the interest income allocated to such tax-exempt dividends is derived from interest income on Exempt Obligations.

Senate Bill 6647-B was approved by the New York Legislature in 1986 without dissent for the stated purpose of correcting the inequitable differentiation under the Tax Law between taxpayers who invest directly in obligations which are exempt from New York State tax and taxpayers who invest indirectly in such obligations through a RIC. This is clearly and broadly stated in the justification included in the memorandum of the Sponsors in support of the bill:

Presently, individuals are permitted to exclude the interest they receive on obligations of the United States from their income subject to the State's personal income tax. Although regulated investment companies are treated as "conduits" for tax purposes, there is the anomalous situation, in that individuals receiving such interest directly can exclude it from income subject to State income tax, but those receiving such interest as distributions from regulated investment companies, cannot take such an exclusion.

This legislation would correct this inequity by permitting these individuals to treat this income as the interest from obligations of the United States. As previously acknowledged by Congress, investors who wish to obtain the advantages of expert management and diversification available to them through a regulated investment company, who might otherwise not be able to afford such services, should be permitted to treat such income as if they had invested in these obligations directly.

The July 14, 1986 letter of Commissioner of Taxation and Finance Roderick Chu to the Governor in support of the bill, the July 22, 1986 Budget Report recommending approval of the bill and the July 21, 1986 memorandum of the Department of Commerce recommending approval uniformly state this legislative purpose.

Furthermore, these materials broadly state the effect of Senate Bill 6647-B. Commissioner Chu's letter speaks of its application to interest on "Federal obligations." The Budget Report makes the intent of the legislature even more clear:

The bill would amend paragraph (1) of section 612(c) of the Tax Law to add a modification reducing Federal adjusted gross income. . .for interest on obligations or securities of the United States or its instrumentalities when such earnings are distributed, as dividends, by a regulated investment company, 50% or more of the assets of which are represented by such Federal obligations or securities. (emphasis added).

As noted above, "obligations of the United States" is not defined in the Tax Law. The juxtaposition of section 612(c)(2) of the Tax Law which by its terms deals with "interest or dividend income on obligations or securities of any authority, commission or instrumentality of the United States" should not be construed to suggest a narrow construction of the phrase. The legislative history of Senate Bill 6647-B discussed herein provide substantial reasons to construe the phrase broadly in the context of the RIC pass-through provisions of section 612(c)(1) of the Tax Law. Furthermore, the argument for a narrow construction based upon the juxtaposition of section 612(c)(2) of the Tax Law is. . . diluted by the fact that adoption of the RIC pass-through rule of section 612(c)(1) of the Tax Law was by amendment to the statute and was not contemporaneous with the adoption of section 612(c)(2) of the Tax Law.

In Bernstein Government Short Duration Portfolio of Sanford C Bernstein Fund, Inc., Adv Op Comm T&F, April 11, 1989, TSB-A-89(4)I, it was held that the dividends received by individuals from RIC's that invest in obligations of the United States and its possessions is treated as interest income pursuant to section 612(c)(1) of the Tax Law, and such individuals may look to TSB-M-86(8)I for guidance in determining what is meant by "obligations of the United States and its possessions."

Therefore, in accordance with the understanding of the meanings of the RIC pass-through rule evidenced at the time of its enactment, it is concluded (a) that the Petitioner's Exempt Obligations are "obligations of the United States" for purposes of the RIC pass-through rule of section 612(c)(1) of the Tax Law and (b) that the Petitioner's shareholders may treat tax-exempt dividends attributable to interest on such Exempt Obligations as a subtraction item for purposes of section 612(c)(1) of the Tax Law if the relevant asset and notice requirements are satisfied.

DATED: December 5, 1991

s/PAUL B. COBURN
Deputy Director
Taxpayer Services Division

NOTE: The opinions expressed in Advisory Opinions
are limited to the facts set forth therein.