

OPINION OF COUNSEL

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) which are attributable to interest on federal obligations.

The question arises especially with regard to mutual funds which pay exempt-interest dividends. Under Internal Revenue Code section 852(b)(5)(B), an exempt-interest dividend is treated as interest on an obligation of a state or a political subdivision thereof and is excluded from Federal gross income.

Shortly after the enactment of the exempt-interest dividend provisions of the Code by the 1976 Tax Reform Act (P.L. 94-455), this Department held that under the personal income tax, the part of an exempt interest dividend attributable to interest on obligations of other states was subject to tax and had to be added to adjusted gross income under section 612(b)(1) of the Tax Law. The basis of the exemption from tax was the exclusion of exempt-interest dividends from Federal gross income. Since New York starts the computation of its tax with Federal adjusted gross income, the exclusion from Federal gross income acted also to exempt such amounts from New York's income tax. However, under Tax Law section 607, terms used in Article 22 are given the same meaning as when used in the Internal Revenue Code in a comparable context. Since the Code provides that an exempt-interest dividend is treated as income from a state obligation, the term in Tax Law Section 612(b)(1) "Interest income on obligations of any state other than this state..." was held to include an exempt-interest dividend to the extent that it is derived from interest on obligations of other states. Hence, such amounts were held to be taxable by New York.

The addition to Federal adjusted gross income of portions of exempt-interest dividends under section 612(b)(1) recognizes the nature of the underlying interest income as being derived from obligations of other states. The inquiry then becomes, can the State recognize the source of a portion of an exempt-interest dividend as being interest on obligations of other states, and thereby subject such portion to tax, but fail to recognize the source of a dividend as being interest on Federal obligations, and by so doing refuse to exempt such dividends from the State's income tax? Interest income from obligations of the United States is not subject to the tax (Tax Law, § 612 (c)(1)).

There is no provision in the Internal Revenue Code under which the source of a dividend is recognized as being interest on Federal obligations, or under which such dividend is given special tax treatment. For instance, dividends paid by mutual funds, including those dividends which are derived from interest on Federal obligations, are eligible for the \$100 dividend exclusion under Internal Revenue Code section 116, although subject to certain limitations (I.R.C. § 116(c)(2)). Therefore, for Federal income tax purposes, such dividends are treated as dividends and are not treated as interest. Section 116(a) limits the exclusion for dividends to amounts received "as dividends."

Pursuant to section 607 of the Tax Law, items of income which are characterized as dividends for Federal income tax purposes should also be considered to be dividends for purposes

of the personal income tax. Since corporate dividends are subject to the personal income tax without modification, it is my opinion that the existing statutes require taxation by the State of dividends paid by mutual funds which are derived from interest on Federal obligations.

November 29, 1979

s/Ralph Vecchio  
Deputy Commissioner & Counsel

This opinion has been unanimously concurred with by the State Tax Commission at a meeting held this date.

s/Paul B. Coburn  
Secretary  
State Tax Commission