PRIVATE TAXPAYER RULING LR00-004

June 27, 2000

The following private taxpayer ruling is in response to your letter of May 18, 2000. Your letter requests a determination with respect to Arizona income tax consequences of certain distributions which may be made to shareholders of … a regulated investment company. The following is a restatement of the facts as presented in your letter.

Statement of facts:

… (the "Trust") was organized as a Massachusetts business trust on …, and is registered as an open-end management investment company with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940. … (the "Fund) is a portfolio series of the Trust that is treated as a separate corporation for federal income tax purposes pursuant to § 851(g) of the Internal Revenue Code of 1986 as amended (the Code). The Fund has qualified and expects to continue to qualify as a "regulated investment company" under § 851 of the Code and has qualified and expects to continue to qualify to pay "exempt-interest dividends" under Code § 852(b)(5). The Fund invests predominately in Arizona State, municipal, or county obligations (Arizona obligations) and U.S. Territorial obligations. Shares of the Fund are offered and sold to individuals and other members of the general public.

The Fund proposes to invest in … (the Money-Market Fund). The Money-Market Fund is a portfolio series of … that is registered with the SEC as an open-end management company and was organized as a Delaware business trust on …. Like the Fund, the Money-Market Fund is treated as a separate corporation for federal income tax purposes pursuant to § 851(g) of the Code. The Money-Market Fund has qualified and expects to continue to qualify as a "regulated investment company" under § 851 of the Code and has qualified and expects to continue to qualify to pay "exempt-interest dividends" under Code § 852(b)(5). The Money-Market Fund is a "money market fund" governed by rules set forth in 17 CFR § 270.2a-7 under the 1940 Act. As of August 31, 1999, 99.9% of the Money-Market Fund's assets consisted of Arizona obligations and U.S. Territorial obligations. Shares of the Money-Market Fund are offered and sold to individuals and other members of the general public.

Issue:

Are distributions to shareholders of the Fund exempt from Arizona income tax when such distributions are attributable to interest on Arizona obligations and United States Territorial obligations held by the Money-Market Fund?

Your position:

Regulated investment companies are recognized as "flow-through" entities for Arizona income tax purposes. Therefore, distributions to shareholders by the Fund that are attributable to interest on Arizona obligations and United States Territorial obligations held indirectly through the Fund's investment in the Money-Market Fund should be treated as exempt from Arizona income tax.

Applicable law:

Arizona Constitution, Article 9, § 2 exempts the income from Arizona State, municipal, and county bonds from Arizona taxation.

Arizona Revised Statutes (A.R.S.) § 43-1001 defines "Arizona gross income" and "Arizona adjusted gross income" for purposes of a resident individual's Arizona income tax computation.

A.R.S. § 43-1021 requires certain additions to Arizona gross income in computing Arizona adjusted gross income.

Internal Revenue Code (I.R.C.) § 103 and Treasury Regulation § 1.103-1(a) provide that gross income for federal income tax purposes does not include interest on obligations of a state, territory or possession of the United States, the District of Columbia, or any political subdivision thereof.

I.R.C. § 852(b)(5)(B) provides that an "exempt interest dividend" of a regulated investment company is treated by shareholders as an item of interest excludable from gross income under I.R.C. § 103 for federal income tax purposes.

48 United States Code (U.S.C.) § 745 prohibits state taxation of bonds issued by the Government of Puerto Rico.

48 U.S.C. § 1403 prohibits state taxation of bonds issued by the Government of the Virgin Islands.

48 U.S.C. § 1423a prohibits state taxation of bonds issued by the Government of Guam.

48 U.S.C. § 1670 prohibits state taxation of industrial development bonds issued by the Government of American Samoa.

Discussion:

I.R.C. § 103(a) provides, with certain exceptions, that gross income for federal income tax purposes, does not include interest on any state or local bond. Treasury Regulation § 1.103-1

(a) provides that interest upon obligations of a state, territory or possession of the United States, the District of Columbia, or any political subdivisions thereof, is not includible in gross income for federal income tax purposes except as provided in I.R.C. §§ 103(c) and 103(d).

A.R.S. § 43-1001 provides that the starting point for the Arizona income tax computation for a resident individual is federal adjusted gross income (Arizona gross income). Therefore, interest on Arizona obligations and United States Territorial obligations excluded from federal gross income will similarly be excluded from Arizona gross income.

When computing Arizona adjusted gross income, A.R.S. § 43-1021.4 requires an addition to Arizona gross income of the amount of interest income received on obligations of any state, territory or possession of the United States, or any political subdivision thereof, located outside the state of Arizona. However, with respect to United States Territorial obligations, the federal law that authorizes the Territorial obligation may prohibit state taxation of such obligation. When preemptive federal law prohibits state taxation of a United States Territorial obligation, the addition required by A.R.S. § 43-1021.4 does not apply and the interest income is exempt from Arizona income tax.

I.R.C. § 852(b)(5) addresses the payment of exempt interest dividends by a regulated investment company. I.R.C. § 852(b)(5)(B) provides that an exempt interest dividend shall be treated by shareholders for federal income tax purposes as an item of interest excludible from gross income under I.R.C. § 103(a).

Therefore, an exempt interest dividend attributable to Arizona obligations and United States Territorial obligations excluded from a shareholder's federal gross income pursuant to I.R.C. §§ 103(a) and 852(b)(5)(B), will similarly be excluded from the shareholder's Arizona gross income (federal adjusted gross income). When computing Arizona adjusted gross income, the shareholder is not required to modify (add back) the portion of the exempt interest dividends attributable to interest on a United States Territorial obligation when federal law prohibits state taxation of the obligation.

Conclusion and ruling:

On the basis of the information provided, we rule that an exempt interest dividend of the Fund attributable to interest on Arizona obligations held by the Money-Market Fund is exempt from Arizona income tax when the dividend is excluded from a shareholder's federal gross income pursuant to I.R.C. §§ 103 and 852(b)(5).

On the basis of the information provided, we rule that an exempt interest dividend of the Fund attributable to interest on a United States Territorial obligation held by the Money-Market Fund

is exempt from Arizona income tax when the dividend is excluded from a shareholder's federal gross income pursuant to I.R.C. §§ 103 and 852(b)(5) and federal law prohibits state taxation of the obligation.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determination in this taxpayer ruling is the present position of the department. This determination is subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.