

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

TSB-A-91 (11) I
Income Tax
December 30, 1991

STATE OF NEW YORK

COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. I910822B

On August 22, 1991, a Petition for Advisory Opinion was received from Franklin New York Tax-Exempt Money Fund¹, Franklin New York Insured Tax-Free Income Fund², Franklin New York Tax-Free Income Fund, Inc.³, Franklin Federal Tax-Free Income Fund⁴, Franklin Insured Tax-Free Income Fund⁵, Franklin High Yield Tax-Free Income Fund⁶, and Franklin Puerto Rico Tax-Free Income Fund⁷ (collectively referred to as the "Taxpayer Funds") 777 Mariners Island Boulevard, San Mateo, California 94404.

The issue raised by Petitioners, the Taxpayer Funds, is whether for personal income tax purposes exempt-interest dividends, attributable to interest on New York municipal obligations and obligations of United States territories and possessions that are paid by a mutual fund ("lower tier fund") to other mutual funds ("upper tier funds") that are similarly qualified to pay exempt-interest dividends, may be excluded from adjusted gross income when paid by the upper tier funds to shareholders who are subject to the New York State or City Personal Income Tax.

¹A series of the Franklin New York Tax-Free Trust, an open-end management investment company organized as a Massachusetts business trust in 1986.

²Also a series of the Franklin New York Tax-Free Trust (see note 1). The fund began operations on May 1, 1991.

³An open-end management investment company organized as a New York corporation in 1982.

⁴An open-end management investment Company organized as a California corporation in 1982.

⁵A series of the Franklin Tax-Free Trust, an open-end management investment company organized as a Massachusetts business trust in 1984.

⁶Ibid.

⁷Ibid.

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Pursuant to an amended and restated application filed with the Securities and Exchange Commission ("SEC") on May 17, 1991, certain mutual funds included among The Franklin Group of Funds ("Franklin") are seeking SEC approval under sections 6(c) and 17(b) of the Investment Company Act of 1940 and Rules 17d-1 thereunder for an exemptive order that would permit certain Franklin funds to invest their short-term cash balances in other Franklin funds that are specifically designed to provide the liquidity necessary for short-term investments. It is intended that the transactions proposed in the amended and restated application ("SEC Application") will be carried out immediately upon receipt of SEC approval and amendment of the funds' policies, as appropriate.

As set forth in the SEC Application, several of Franklin's money funds ("Money Funds") will sell shares to Franklin funds which are not Money Funds ("Funds") as a means for the Funds to invest their otherwise uninvested cash balances at the end of a trading day. Included among the Funds and the Money Funds are funds which invest predominantly in tax-exempt obligations and which pay exempt-interest dividends excludable from adjusted gross income under section 852(b)(5) of the Internal Revenue Code of 1986, as amended (the "IRC"), section 612 of the Tax Law and section 11-1712 of the New York City Administrative Code.

Petitioner, Franklin New York Tax-Exempt Money Fund ("Tax-Exempt Money Fund") is a New York tax-exempt Money Fund which will sell its shares to the other six Petitioners that are tax-exempt Funds.

All Petitioners, except for the Franklin New York Insured Tax-Free Income Fund, have elected to be treated as regulated investment companies ("RICs") under the IRC and qualified as such for their preceding fiscal years and have each qualified to pay and have paid exempt-interest dividends excludable from adjusted gross income under section 852(b)(5) of the IRC and section 612 of the Tax Law and section 11-1712 of the New York City Administrative Code in their prior fiscal years. The Franklin New York Insured Tax-Free Income Fund intends to elect to be treated as a RIC for its first fiscal year ending December 31, 1991. Each Petitioner intends to qualify as a RIC during the current and future years. Each Petitioner intends to qualify to pay and to pay such exempt-interest dividends under the applicable federal and New York provisions in the current and future years.

The Tax-Exempt Money Fund had invested 94.2% and 1.8%, respectively, of its invested assets in tax-exempt obligations of New York municipal issuers and United States territories and possessions as of its fiscal year ended December 31, 1990, and during such fiscal year 100% of the fund's distributions were exempt-interest dividends for federal, New York State and New York City personal income tax purposes. A small portion of the fund's assets were cash balances maintained for liquidity purposes. The other Petitioners will satisfy the 50% asset test of section 852(b)(5) of the IRC by direct holdings of obligations described in section 103(a) of the IRC. In addition, each Petitioner distributes all of its net investment income and net short-term and long-term capital gains so as to not be liable for any federal income or excise taxes or state franchise or income taxes.

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Section 612(a) of the Tax Law provides: "[t]he New York adjusted gross income of a resident individual means his federal adjusted gross income as defined in the laws of the United States for the taxable year, with the modifications specified in this section."

Section 62 of the IRC provides that adjusted gross income means gross income less certain deductions.

Section 103(a) of the IRC provides that gross income does not include interest on any state or local bond. Section 1.103-1(a) of the Treasury Regulations, promulgated thereunder, provide that "[i]nterest upon obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (hereinafter collectively or individually referred to as "State or local government unit") is not includable in gross income "

Section 612(b)(1) of the New York State Tax Law provides that when computing New York adjusted gross income a taxpayer shall add to federal adjusted gross income "interest income on obligations of any state other than this state, or of a political subdivision of any such other state, to the extent not properly includible in federal adjusted gross income". There is no such required addition of interest income from obligations of the State of New York, its political subdivisions or of possessions or territories of the United States. Exempt-interest dividends constitute interest for the purposes of section 612 of the Tax Law. Municipal Fund for Temporary Investment, Inc., St Tax Comm Adv Op, July 18, 1980, TSB-H-80-(245)-I.

Section 116.2(a) of the New York State Personal Income Tax Regulations provides:

Interest income on obligations of any state, other than New York State, or of a political subdivision of any such other state (including that part of an exempt-interest dividend, as described in subparagraph [BI of paragraph [5] of subsection [bi of section 852 of the Internal Revenue Code, paid by a regulated investment company which is derived from any such obligations), unless created by compact or agreement to which New York State is a party, to the extent not properly includible in Federal adjusted gross income.

Exempt-interest dividends are paid by a RIC pursuant to section 852(b)(5) of the IRC. If all of the other requirements of section 852 of the IRC have been met, section 852(b)(5) of the IRC provides that a RIC may pay exempt-interest dividends if, at the close of each quarter of its taxable year, at least 50% of the value of the total assets of the RIC consist of obligations described in section 103(a) of the IRC. An exempt-interest dividend paid must be designated as such in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year.

Section 852(b) (5) (B) of the IRC states that:

An exempt-interest dividend shall be treated by the shareholders for all purposes of this subtitle as an item of interest excludable from gross income under section 103(a). Such purposes include but are not limited to--

- (i) the determination of gross income and taxable income,
- (ii) the determination of distributable net income under subchapter J,
- (iii) the allowance of, or calculation of the amount of, any credit or deduction, and
- (iv) the determination of the basis in the hands of any shareholder of any share of stock of the company.

Therefore, the amount of exempt-interest dividends issued by a RIC that is excluded from a shareholder's federal gross income pursuant to sections 10B(a) and 852(b) (5) of the IRC, is excluded from federal adjusted gross income, the starting point in computing the shareholder's New York adjusted gross income.

Likewise, where a RIC meets all of the requirements of section 852 of the IRC and pays exempt-interest dividends pursuant to section 852(b) (5) of the IRC to a shareholder that is another RIC, and that other RIC also meets all the requirements of section 852 of the IRC and also pays exempt-interest dividends pursuant to section 852(b) (5) of the IRC to shareholders who are subject to New York Personal Income Tax, the amount of such exempt-interest dividends received by a shareholder is excluded from the shareholder's federal gross income pursuant to section 10B(a) and 852(b) (5) of the IRC. Such exempt-interest dividends are also excluded from the shareholder's federal adjusted gross income, the starting point, for computing the shareholder's New York adjusted gross income.

The only modification contained in section 612 of the Tax Law that affects the shareholders of a RIC that pays exempt-interest dividends is section 612(a) which provides an add modification for the portion of such exempt-interest dividends derived from obligations of any state, other than New York, or a political subdivision of any such other state, to the extent not includible in federal adjusted gross income.

Accordingly, if for federal income tax purposes, a shareholder receives exempt-interest dividends derived from New York municipal obligations and obligations of United States territories and possessions that are excluded from the shareholder's federal adjusted gross income, such exempt-interest dividends are excluded from New York adjusted gross income.

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Section 11-1712(a) and (b)(1) of the New York City Administrative Code are identical to section 612(a) and (b)(1) of the Tax Law. Therefore, for a shareholder subject to the New York City Personal Income Tax, the principles described herein and the conclusion reached for New York State Personal Income Tax purposes will also apply to the application of the New York City Personal Income Tax.

DATED: December 30, 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.