

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

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Income Tax
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Taxation of Dividends Paid by Regulated Investment Companies

Chapter 535 of the Laws of 1986 has amended Section 612(c)(1) of the Tax Law with respect to the treatment, for personal income tax purposes, of dividends paid by regulated investment companies (mutual funds) that invest in obligations of the United States and its possessions (federal obligations). The law, as amended, will permit a shareholder of a regulated investment company that meets the conditions set forth below to subtract from federal adjusted gross income that portion of the shareholder's distribution from the company that is derived from interest on federal obligations. This new provision will apply to all distributions made after April 1, 1987.

For shareholders of a regulated investment company to be eligible for the new subtraction, the regulated investment company must have at least 50% of the value of its total assets (as defined in Section 851 of the Internal Revenue Code) invested in federal obligations at the close of each quarter of its taxable year. Once this requirement is met, the portion of the interest dividends received by a shareholder that may be subtracted from federal adjusted gross income is based upon the portion of income received by the company that is derived from federal obligations. Where 100% of the income of the company is derived from interest on federal obligations, 100% of the dividends received by the shareholders may be subtracted. Where less than 100% of the income of the company is derived from interest on federal obligations, the amount of the subtraction is to be determined as follows:

$$\frac{\text{Interest income on federal obligations less expenses attributable to such income}}{\text{Regulated investment company's taxable income}} = \text{Percent of dividends received by shareholders that qualify for the subtraction}$$

A written notice of the amount of dividends that qualify for the New York subtraction modification must be mailed to the shareholders of the regulated investment company within 45 days after the close of the company's taxable year.

The amendment applies to all distributions made after April 1, 1987.

Dividends attributable to federal obligations distributed by all regulated investment companies prior to April 1, 1987, and dividends attributable to such obligations distributed after April 1, 1987, by regulated investment companies that do not meet the 50% asset requirement remain fully taxable for New York State purposes.

The following example illustrates the operation of the new law:

EXAMPLE

Computation for Regulated Investment Company

The regulated investment company meets the 50% requirement of New York State Tax Law Section 612(c)(1) and receives income from the following sources:

Capital gains (from the sale of stock or securities)	\$ 20,000
Interest income (from federal obligations)	70,000
Dividends (from corporations)	<u>10,000</u>
Total	\$100,000
Expenses (\$10,000 of which are directly related to interest income on federal obligations)	<u>20,000</u>
Taxable income	<u>\$ 80,000</u>

The regulated investment company distributed the entire income of \$80,000 to its shareholders. The percentage of this distribution that qualifies for the New York subtraction is computed as follows:

$$\frac{\$70,000 - \$10,000}{\$80,000} = 75\% \text{ (Percentage of dividends that qualify for New York subtraction)}$$

Computation for Shareholder

An individual shareholder receives dividend distributions of \$2,000 in 1987 (\$200 before April 1, 1987 and \$1,800 after April 1, 1987) from the above regulated investment company. The amount of these dividends qualifying for the New York subtraction is computed as follows:

$$\begin{aligned} &\$1,800 \text{ (dividends distributed after April 1, 1987)} \\ &\times .75 = \$1,350 \end{aligned}$$