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Taxation of Dividends Paid by Regulated Investment Companies

Two questions have been raised in regard to the New York State taxation of dividends paid by regulated investment companies (mutual funds) which invest all of their assets in repurchase agreements whose subject matter consists of U.S. obligations. The first question is whether the dividends constitute interest income on U.S. obligations for purposes of the subtraction modification under Section 612(c)(1) of the Tax Law. The second question is whether the value of these repurchase agreements, in the portfolio of the regulated investment companies, can be counted toward meeting the 50 percent asset test of Section 612(c)(1). The following, which is printed in its entirety, is an Opinion of Counsel dealing with these questions.

OPINION OF COUNSEL

Taxation of Dividends Paid by Regulated Investment Companies Investing in Repurchase Agreements

May 4, 1988

Dear:

This is in reply to your letter of addressed to Commissioner Chu. There, you requested a Ruling as to New York State's position regarding the personal income taxation of dividends paid out by a mutual fund ( ) which invests all of its assets in repurchase agreements (repos) whose subject matter consists of obligations of the United States and its possessions. For the reasons stated herein, it is my opinion that such dividends, to the extent they are traceable to the aforementioned repos, do not represent interest income from obligations of the United States and its possessions and, thus, are fully taxable to the recipients under Article 22 of the Tax Law. In addition, for the same reasons as stated herein, it is my opinion that the value of the aforementioned repos, in the portfolio of the mutual fund, may not be taken into account in calculating the "50% asset test" for purposes of the "minus modification" of Tax Law section 612(c)(1).

Section 612(c)(1) of the Tax Law provides, inter alia, that interest income derived from obligations of the United States and its possessions, to the extent includible in Federal gross income, is a minus modification for purposes of computing the Personal Income Tax (Article 22 of the Tax Law); that is, such interest is subtracted from Federal adjusted gross income in arriving at New York adjusted gross income. Section 612(c)(1) also provides, inter alia, that subject to certain qualification requirements, the same minus modification applies to shareholders of a mutual fund if the mutual fund owns the interest-bearing Federal obligations and passes through such interest to the fund's shareholders in the form of mutual fund dividends. (Mutual funds are also known as "RIC's", i.e., regulated investment companies as defined in Internal Revenue Code section 851.) The major qualification requirement under section 612(c)(1) is that at least 50 percent of the value of the RIC's total assets must consist of obligations of the United States and its possessions; this requirement is commonly known as the 50 percent asset test.

In recent years, repos have become the subject of a substantial body of legal literature. See, e.g., the exhaustive decision in Matter of Bevill, Bresler & Schulman Asset Management Corp., 67 Bankr. Rep. 557 (D.N.J. 1986), and the authorities cited therein. As the Bevill court said, at p. 594:

> "The cases which have addressed the legal characterization of repos and reverse repo transactions can be divided into three broad categories: tax cases, securities fraud cases, and bankruptcy cases."

Bevill itself was a bankruptcy case. In distinguishing the tax and securities fraud cases, Bevill stated:

> "The vast majority of these cases are inapposite either because they involve commercial transactions which are factually distinguishable in certain vital respects from the repo and reverse repo transactions which are the subject of these test cases, or because the courts chose to characterize the transactions in a particular way for reasons which have no bearing on the analysis required in these [bankruptcy] proceedings." Id.

Thus, notwithstanding the Bevill court's application of what it believed to be the substantive law of the State of New York to the bankruptcy issues before it, I recognize -- as did the Bevill court -- that such an application of New York law would not be compelled for (New York) tax law issues. Therefore, I do not believe that Bevill is authority for the proposition that a repo entails a true sale and repurchase, as has been contended.

The central issue at hand, then, remains the typical repo issue, namely: are these repos secured loans or, rather, are they more properly to be treated as distinct purchases and (re)sales? The tax consequences will flow directly from the answer to this question.

Very recently, authorities in both Illinois and Virginia have considered sets of facts and issues indistinguishable from those which you now present: the state taxation of shareholders of a RIC that invests assets in Federal paper repos, first "buying" the Federal obligations and then "reselling" them to the same party. See, Andras v. Illinois Department of Revenue, 154 Ill. App. 3d 37, 106 Ill. Dec. 732, 506 N.E. 2d 439 (2d District 1987), lv. app. den., No. 63703 (Oct. 7, 1987, Illinois Supreme Court), cert. den., 108 S. Ct. 1223 (Mar. 21, 1988); Illinois Department of Revenue Information Bulletin, FY 87-25 (May 1987); Virginia Department of Taxation, Ruling of the Commissioner (P.D. 87-186, July 7, 1987). See also, Virginia Tax Bulletin 82-3 (April 1982).

The reasoning of the Illinois court in Andras is particularly instructive and bears repeating here:

> "Plaintiffs next argue that the Department incorrectly classified the Trust's repurchase agreements as secured loans rather than sales. The transactions are arranged as follows. The Trust [a RIC] agrees to purchase certain U.S. Government securities from a bank or other seller and simultaneously agrees to resell the same securities to the same party on a certain, fixed date, which is generally within a few days of the original sale date. The seller agrees to pay the Trust interest at a fixed rate for the period between the original sale and the repurchase. The record contains some representative repurchase agreements supplied by the Trust. Some of the agreements refer to the original purchase price as 'principal' and to the government securities as 'collateral' ....
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> "In reviewing similar transactions involving municipal bonds, Federal courts have consistently held that the Federal income tax exemption provided for income received from State or municipal obligations (26 U.S.C. sec. 103(a)(1954)) is available only to the taxpayer who actually owns the securities -- i.e., the taxpayer who has the right to dispose of them and who bears the risk of a profit or loss. (See American National Bank v. United States (5th Cir. 1970), 421 F. 2d 442, 451, and cases cited therein.) ... If the Trust is not the true owner of these securities, but is merely loaning the sellers the securities' purchase price and thereby earning otherwise taxable interest income, we conclude that it may not shelter that income from State taxation by allowing the borrowers to secure the loans with tax-exempt Federal securities.

"In determining whether or not a repurchase transaction is actually a loan, Federal courts consider the entire transaction, and look to the following specific factors, which, if present, tend to indicate that the transaction is a loan: (1) whether the seller could require the purchaser to resell the securities; (2) whether the purchaser could require the seller to repurchase them; (3) whether the agreement provides either party a specific remedy in the event that the other defaults; (4) whether the seller agreed to pay interest at a stipulated rate between the sale and resale; and (5) whether the amount advanced does not necessarily equal the fair market value of the securities sold. (see Citizens National Bank v. United States (1977), 551 F. 2d 832, 842, 213 Ct. Cl. 236.) Other indications of a loan are: (6) whether the identical securities are bought and sold, and (7) whether the purchaser may sell the securities for the seller's account in the event of a default. See I.R.S. Rev. Rul. 74-27 (1974-1 C.B. 24). See also, I.R.S. Rev. Rul. 82-144 (1982-2 C.B. 34) (transaction held to be purchase where the purchaser could sell the securities at will); I.R.S. Rev. Rul. 77-59 (1977-1 C.B. 196) (transaction was found to be loan only and the purchaser's assets were found not to be the securities themselves, but the seller's obligation to repay the funds loaned). Here the Trust and the sellers affirmatively agreed to a repurchase transaction involving the same securities at the time of the sale, and either could therefore properly require the other to perform. And while the agreements do not expressly provide mutual remedies in the event of a default, plaintiffs have stated that the Trust is authorized to sell the securities if the seller defaults. There is no indication that a default sale would relieve the seller of the obligation to pay the agreed amount, and we therefore perceive that such a default sale would only act as a credit against any amount still owed by the seller under the original agreement. In addition, all of the sample agreements clearly set a specific rate of interest.

"The Department has not argued that the sale amounts do not accurately reflect the value of the securities, and we will therefore assume that they do. The evidence nevertheless clearly indicates that the Trust accepted none of the risks of ownership, and we therefore conclude that the transactions were secured loans rather than sales. See American National Bank v. United States (5th Cir. 1970), 421 F. 2d 442, 451 .... We therefore affirm the circuit court's conclusion that income derived by the Trust from these repurchase agreements is not tax-exempt.

> "The decision of the circuit court is . . . remanded with directions to permit taxpayers to deduct from their gross income that proportion of the dividends they received from the Trust that is attributable to U.S. Government securities, but not the amount attributable to income from repurchase agreements."

Andras v. Illinois Department of Revenue, supra, 506 N.E. 2d at 443-444.

It is my opinion that both the rationale and conclusion reached in Andras, concerning the repo issue, are sound and should be followed for the matter at hand.

Note, also, that the Virginia Department of Taxation has taken a position which accords with that expressed in Andras. Responding to inquiries from several mutual funds, a recent Ruling of the Commissioner (P.D. 87-186, July 7, 1987) stated, in relevant part:

> "You also requested a ruling regarding the taxability, for Virginia individual income tax purposes, of the interest and dividends paid to Virginia residents from [a] mutual fund. This fund may invest only in marketable securities issued or guaranteed by the United States Government, by various agencies of the United States Government and by various instrumentalities which have been established or sponsored by the United States Government ('U.S. Government Securities'). It is the present policy of this fund to invest 100% of its assets in overnight repurchase agreements with government securities dealers recognized by the Federal Reserve Board or with member banks of the Federal Reserve System. The agreements are collateralized by U.S. Government Securities.
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> > "Section 630-2-322(C)(2)(d) of the Virginia Individual Income Tax Regulations provides:
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> > > 'Repurchase agreements are usually obligations issued by financial institutions which are secured by U.S. obligations exempt from Virginia income taxation .... In such cases the interest paid by the financial institutions to purchasers of repurchase agreements does not qualify for the subtraction. Repurchase agreements issued following current commercial practice will invariably be regarded as obligations of the issuing financial institution. However, if the purchaser is regarded as the true owner of the underlying exempt obligation, the interest will qualify for the subtraction even though collected by the seller and distributed to the purchaser. Any claim of such ownership must be substantiated, by a taxpayer claiming a subtraction.'

"Based upon the information that you have provided and upon the above regulation section, such dividends paid by this fund would currently be subject to the Virginia individual income tax."

I am aware of two state tax cases which, at first glance, might seem to hold contrary to the Illinois and Virginia view. See, Matz v. Michigan Department of Treasury, 155 Mich. App. 778, 401 N.W. 2d 62 (1986); In re Thomas C. Sawyer Estate, No. S101-84 (Chittenden County, Vermont, Superior Court, Feb. 20, 1986), aff'd, No. 86-177 (Dec. 11, 1987, Vermont Supreme Court). However, the concern in Matz was with whether -- absent a statute on point -- dividends from a mutual fund which admittedly owned Federal securities would retain their character attribute as Federally exempt interest, essentially passed through from the mutual fund. Although repos were involved, and the facts seem akin to those considered by the above Illinois and Virginia authorities, Matz never considered the present issue of whether the mutual fund indeed owned the Federal securities. The loan versus sale issue was passed over without mention. Instead Matz took it for granted that the mutual fund was, as stipulated, the true owner of the Federal securities. The same is true of Sawyer. Thus, neither Matz nor Sawyer addressed the instant issue and do not, in reality, hold contrary to either Andras or the Ruling of the Virginia Tax Commissioner.

Based on the facts set forth in your correspondence, it is my opinion that your repos are virtually identical to those considered by the authorities in Illinois and Virginia. I believe that the loan versus sale issue turns on whether the purchaser/ lender becomes endowed with the economic benefits and burdens of ownership of the (Federal) securities. The chief indicia of such endowment, as alluded to in Andras, are (1) the right freely to dispose of or pledge the securities to a third party, and (2) the accrual to such party of the opportunity for profit and loss deriving from changes in the market value of the securities. Since this second indicium is lacking in your facts, just as it was lacking in Andras, I conclude that there is no transfer of ownership of the instant Federal securities whereby it can be said that, for purposes of section 612(c)(1) of the Tax Law, your mutual fund is ever the owner of the Federal securities.

Only if your RIC were the true owner of the Federal securities would it and its shareholders qualify for the benefits of Tax Law section 612(c)(1). Under fundamental principles of taxation, the owner of securities -- and only the owner -- is charged with the interest income derived therefrom; interest income cannot be assigned without a true shift in ownership of the underlying obligation. "(F)ruit is not to be attributed to a different tree from that on which it grew." Helvering v. Horst, 311 U.S. 112, 120 (1940). Accord, Lucas v. Earl, 281 U.S. 111 (1930); Heaton v. Heaton, 55 N.Y.S. 2d 154 (N.Y. County 1945). It follows, too, that the attributes of the fruit of one tree may not be assigned to the fruit of another.

Your letter had surmised: "It is our understanding that New York does not tax dividends paid by a regulated investment company (as that term is defined under the Internal Revenue Code) which are derived in whole or in part from interest on Federal obligations." Clearly, that statement is overly broad. A proper understanding of New York's law on the subject must take into account both the more limited rule of section 612(c)(1) and the gist of this letter.

CONCLUSION

With your mutual fund never the true owner of the Federal securities, the following results obtain: (1) the interest income received by the mutual fund as the fruit of the repurchase agreement transactions does not constitute interest income from United States obligations in the hands of the mutual fund shareholders and, thus, does not qualify for the minus modification of Tax Law section 612(c)(1); and, (2) the value of the repurchase agreements, in the portfolio of the mutual fund, is not counted toward meeting the 50 percent asset test of section 612(c)(1).

Sincerely,

William F. Collins
Deputy Commissioner and Counsel

Cross References: Taxation of Dividends Paid by Regulated Investment Companies TSB-M-84-(5)-I
TSB-M-86-(7)-I