

MEMO# 2483

January 22, 1991

CALIFORNIA RULES THAT U.S. TERRITORY AND AGENCY OBLIGATIONS ARE ELIGIBLE FOR PASS-THROUGH TREATMENT

- 1 - January 22, 1991 TO: TAX MEMBERS NO. 1-91 MONEY MARKET MEMBERS - ONE PER
COMPLEX NO. 1-91 RE: CALIFORNIA RULES THAT U.S. TERRITORY AND AGENCY
OBLIGATIONS ARE ELIGIBLE FOR PASS-THROUGH TREATMENT

As we previously informed you, California made two changes last year to section 17145 of the California Taxation and Revenue Code, which provides pass-through treatment for interest paid on U.S. Government, federal agency and territorial obligations. The first change expressly included federal agency and territorial obligations within the group of obligations eligible for pass-through treatment. (See Institute Memorandum to Tax Members No. 20-90 and Money Market Members - One Per Complex No. 8-90, dated June 15, 1990.) The second change was a "technical amendment" which imposed certain limitations on the amount of income that could be passed through a management company exempt from California tax. Unfortunately, under a literal construction of the statute, this technical amendment could be interpreted to deny pass-through treatment to those agency and territorial obligations that were expressly made eligible for pass-through treatment by the first statutory change. (See Institute Memorandum to Tax Members No. 49-90 and Money Market Members - One Per Complex No. 16-90, dated November 21, 1990.) Because of the confusion created by these conflicting statutory changes, the Institute requested that the California Franchise Tax Board issue a ruling that interest paid on territorial and federal agency obligations which is exempt from California tax when paid directly to an individual investor is eligible for pass-through treatment under California law. (See Institute Memorandum to Tax Members No. 55-90 and Money Market Members - One Per Complex No. 17-90, dated December 13, 1990.) The attached information letter received today by the Institute from the California Franchise Tax Board responds to our ruling request and sets forth the Franchise Tax Board's view as to the proper interpretation of the California pass-through statute. In the information letter, the Franchise Tax Board (1) sets forth the legislative history of the changes made last year to the pass-through provision, (2) observes that under - 2 - established principles of statutory construction the two changes - 3 - must be read together to effectuate the purpose of the law and (3) then concludes that: it is clear that the Legislature intended that interest from obligations which give rise to exempt interest under federal statute when held by an individual, such as obligations of the Commonwealth of Puerto Rico, should be treated as exempt interest for purposes of the limitation imposed by [the most recent change to the pass-through statute]. * * * * We will

keep you informed of developments. Keith D. Lawson Associate General Counsel
Attachment KDL:bmb

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