

MEMO# 2793

May 24, 1991

CONNECTICUT RULES THAT PUERTO RICAN OBLIGATION INTEREST IS TAX EXEMPT IF INCLUDED IN RIC'S EXEMPT-INTEREST DIVIDEND

May 24, 1991 TO: TAX MEMBERS NO. 17-91 MONEY MARKET MEMBERS - ONE PER COMPLEX NO. 11-91 RE: CONNECTICUT RULES THAT PUERTO RICAN OBLIGATION INTEREST IS TAX EXEMPT IF INCLUDED IN RIC'S EXEMPT-INTEREST DIVIDEND

_____ In our most recent survey of state income taxation, Connecticut responded that it taxes regulated investment company ("RIC") dividends which are derived in whole or in part from interest on federal obligations, but does not tax those dividends to the extent that they are attributable to interest on Connecticut obligations. (See Institute Memorandum to Members - One Per Complex No. 51-90, Closed-End Fund Members No. 46-90, Tax Members No. 48-90, Unit Investment Trust Members No. 73-90 and Accounting/Treasurers Members No. 23-90, dated November 21, 1990.) In the attached Ruling, the Connecticut Department of Revenue holds that a RIC's exempt-interest dividends, to the extent that they are attributable to interest derived from Puerto Rican obligations, are exempt from the State's dividend and interest income tax. The basis for the ruling is as follows. 1) Federal law (48 U.S.C. Sec. 745) prohibits states from taxing Puerto Rican obligations. 2) Section 103 of the Internal Revenue Code includes within the definition of state and local obligations exempt from federal tax the obligations of Puerto Rico. 3) Section 852(b)(5) of the Internal Revenue Code provides that exempt-interest dividends paid by a RIC (which are attributable to interest paid on state and local obligations) shall be treated as interest that is excludable from gross income under section 103. 4) Consistent with federal law, Connecticut law treats exempt-interest dividends as interest income for purposes of the Connecticut dividend and interest income tax. - 2 - 5) To the extent that an exempt-interest dividend is attributable to interest derived from Puerto Rican obligations, the Puerto Rican interest income retains its character as Puerto Rican interest and is, therefore, not subject to Connecticut taxation. The ruling does not address the issue of whether RIC dividends attributable to Puerto Rican obligations would be exempt from Connecticut tax if paid in any form other than as an exempt-interest dividend, such as where Puerto Rican obligations are held by a RIC that invests primarily in federal obligations. We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment

abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.