MEMO# 1618

December 26, 1989

PASS-THROUGH OF FEDERAL OBLIGATION INTEREST - NORTH CAROLINA

December 26, 1989 TO: TAX MEMBERS NO. 51-89 MONEY MARKET FUND CHIEF EXECUTIVE OFFICERS NO. 12-89 RE: PASS-THROUGH OF FEDERAL OBLIGATION INTEREST - NORTH CAROLINA ____ North Carolina has modified the manner and extent to which it permits funds to pass through dividends attributable to interest derived from federal obligations free of state tax. Under prior law, pass-through treatment was available for the pro rata portion of the fund dividend attributable to federal obligation interest. Under the new North Carolina law, shareholders reduce their state tax for such interest via a tax credit. Under the amended North Carolina statute, North Carolina shareholders are entitled to a tax credit equal to six percent of the amount of certain dividends received during the taxable year from a "qualified corporation;" the maximum credit is $300 per taxpayer per year. The $300 maximum credit provides an exclusion from tax (at a six percent tax rate) for the first $5,000 of dividends attributable to federal obligation interest. In the case of a married couple where both spouses receive dividends, the $300 maximum credit applies separately to each spouse's dividends. A regulated investment company ("RIC") is a "qualified corporation" if fifty percent or more of its dividends would be deductible, by reason of the state's dividends received deduction, if paid during the taxable year to corporate shareholders. Because a dividends received deduction is provided by North Carolina law for RIC dividends attributable to income which would not be taxed by North Carolina if received directly by corporate shareholders, a RIC is a qualified corporation if fifty percent or more of its dividend income is attributable to interest on federal obligations and/or North Carolina obligations. The attached announcement by the North Carolina Department of Revenue discusses these statutory changes. The announcement's first example illustrates the operation of the tax credit for an individual shareholder receiving both capital gain and ordinary dividend distributions from a RIC investing in United States Government bonds. As $1,500 of the RIC dividend is attributable to federal obligation interest, the shareholder receives a dividend tax credit of $90 ($1,500 x 6%). The mechanism for pass-through treatment for North Carolina state and local obligation interest is also addressed. In essence, the pro rata portion of the dividend attributable to North Carolina interest passes through so long as at least fifty percent of the value of the fund's total assets, at the close of each quarter, consists of state and local bonds. Example 2 illustrates these rules. We will keep you informed of developments. Keith D. Lawson Assistant General Counsel Attachment