

**Administrative Release No. 11**

**Subject: Income from Regulated Investment Companies Which Invest in U.S. Government Obligations and Income from Repurchase Agreement Transactions.**

**I. General**

On August 30, 1990, the Maryland Court of Appeals decided the case of *Comptroller v. First United Bank and Trust, et al.*, 320 Md. 352, 578 A.2d 192 (1990). The issues concerned whether Maryland could tax income that shareholders receive from regulated investment companies (mutual funds) that was derived from:

1. interest from direct holdings of U.S. government obligations; and
2. income on repurchase agreement transactions.

**II. Income Received from Mutual Funds Holding U.S. Government Obligations**

The Court held that mutual fund dividends attributable to interest received by the fund from U.S. government obligations **are exempt from Maryland income tax**. This decision overrules the previous position of the Comptroller and the Attorney General that such dividends or distributions were subject to tax.

The decision affects the 1989 law codified as Section 10-207(c-1) of the Tax-General Article, Annotated Code of Maryland, which provided for a subtraction, under certain circumstances, of a distribution or dividend from a mutual fund of interest attributable to a U.S. government obligation. The statute allowed a subtraction of a portion of the dividend only if "at least 50% of interest received by the mutual fund during its taxable year is from United States government obligations." The Court's decision voided this percentage limitation. Shareholders may subtract that portion of their distribution or dividend received from a mutual fund which represents United States government obligation interest even if the mutual fund receives less than 50% of its interest from United States government obligations.

The Court distinguished its holding regarding the state tax exempt status of dividends received from mutual funds or regulated investment companies

from dividends received from a regular C-corporation. Unlike mutual funds or regulated investment companies, the Court said, "Maryland can tax dividends from a regular C-corporation even though those dividends are derived from interest on federal obligations. A C-corporation is clearly a separate entity for tax purposes."

However, in the case of an S-corporation, Maryland continues to recognize the pass-through character of the income as provided for under the Internal Revenue Code. Dividends received from an S-corporation, unlike a C-corporation, may be subtracted to the extent they represent interest derived from United States government obligations held by the S-corporation.

**III. Income from Repurchase Agreements**

The Court held that the portion of income received by a shareholder from a mutual fund which was derived from its participation in repurchase agreement transactions is **subject to Maryland income tax**. Repurchase agreement transactions were generally described by the fund in this case as "arrangements in which banks, brokers, dealers, and other recognized financial institutions sell U.S. government securities to the Trust (mutual fund) and agree at the time of sale to repurchase them at a mutually agreed upon time and price within one year from the date of acquisition."

The difference between the "sale" price and the price at which the U.S. government obligations are repurchased is the "interest" earned on the transaction. The Court held that the "interest" earned on the transaction was not interest received from a federal obligation, but was interest derived from a loan with the securities held as collateral. Shareholders may not, therefore, subtract that portion of the dividend attributable to repurchase agreement transactions as interest from federal obligations.



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