



## Private Letter Rulings

*"Private letter rulings" are written statements issued to a taxpayer by the department that interpret Wisconsin tax laws to the taxpayer's specific set of facts. Any taxpayer may rely upon the ruling to the same extent as the requestor, provided the facts are the same as those set forth in the ruling.*

*The number assigned to each ruling is interpreted as follows: The "W" is for "Wisconsin," the first two digits are the year the ruling becomes available for publication (80 days after the ruling is issued to the taxpayer), the next two digits are the week of the year, and the last three digits are the number in the series of rulings issued that year. The date following the 7-digit number is the date the ruling was mailed to the requestor.*

*Certain information contained in the ruling that could identify the taxpayer requesting the ruling has been deleted. Wisconsin Publication 111, "How to Get a Private Letter Ruling From the Wisconsin Department of Revenue," contains additional information about private letter rulings.*

The following private letter ruling is included:

### Individual Income Taxes

Modifications — mutual fund distributions  
Wisconsin alternative minimum taxable income

W9339005, July 7, 1993

(p. 34)

✳ W9339005, July 7, 1993

**Type Tax:** Individual Income Taxes

**Issue:** Modifications — mutual fund distributions; Wisconsin alternative minimum taxable income

**Statutes:** Sections 71.05(6)(a)1 and (6)(b)1, and 71.08(1), Wis. Stats. (1991-92)

This letter responds to your request for a private letter ruling on behalf of ABC Company, in regard to the application of Wisconsin income tax to the Wisconsin shareholders of a mutual fund investing in obligations of the United States government, certain United States possessions and territories, and certain Wisconsin agencies and political subdivisions.

### Facts

ABC Company serves as investment advisor to a number of open-end and closed-end investment companies. ABC Company proposes to sponsor a new open-end investment company, or mutual fund, called ABC Mutual Funds, to be organized as a non-Wisconsin corporation. ABC Mutual Funds will be registered with the Securities and Exchange Commission under the Investment Company Act of 1940 as an open-end management investment company.

ABC Mutual Funds will be a series fund offering (initially) three distinct series of shares. Each series of the fund is intended to qualify as a regulated investment company under Subchapter M of the Internal Revenue Code (IRC) of 1986, as amended. Each series will represent an

exclusive interest in a separate portfolio of securities consisting primarily of the obligations of one state, its political subdivisions, and agencies. One such series (hereinafter the "Fund") will invest primarily in certain obligations of Wisconsin agencies and political subdivisions and in the obligations of certain United States territories and possessions. It will also reserve the right to invest, for defensive purposes, in certain other securities, including obligations of the United States Treasury. All of the rulings requested relate solely to the shareholders of the Fund, who are expected to be individuals who are Wisconsin residents.

### Ruling Requested

You request rulings confirming that dividends paid by the Fund that are attributable to interest income which is otherwise exempt from the Wisconsin income tax, will be excluded from the Wisconsin taxable income and the Wisconsin alternative minimum taxable income of shareholders.

### Ruling

1. Dividends paid by the Fund that are attributable to interest earned on obligations of the United States government or its territories and possessions, will be excluded from the Wisconsin taxable income of the Fund shareholders subject to Wisconsin personal income tax.
2. Dividends paid by the Fund that are attributable to interest earned on obligations of the State of Wisconsin or Wisconsin agencies

or political subdivisions, the interest on which is expressly exempted from Wisconsin personal income tax under state statute, will be excluded from the Wisconsin taxable income of the Fund shareholders subject to Wisconsin personal income tax.

3. Dividends paid by the Fund that are attributable to interest earned on obligations of the United States and its territories and possessions and on obligations of the State of Wisconsin or Wisconsin agencies or political subdivisions, the interest on which is exempt from Wisconsin personal income tax under state statute, will be excluded from the Wisconsin alternative minimum taxable income of individuals and fiduciaries.

## Analysis

- I. Exclusion From Gross Income for Mutual Fund Dividends Attributable to Interest on Obligations of the U.S. Government, U.S. Possessions and Territories, and Certain Wisconsin Obligations

The Wisconsin adjusted gross income of individuals and fiduciaries is based on their federal adjusted gross income, with certain adjustments. Secs. 71.01(13) and 71.05, Wis. Stats. (1991-92). Wisconsin individuals must generally add back to federal adjusted gross income any interest received on municipal bonds that was excluded from federal gross income (subject to exclusions otherwise provided for interest earned on specified types of Wisconsin bonds and bonds issued by U.S. territories and possessions). Sec. 71.05.(6)(a)1, Wis. Stats. (1991-92). Conversely, Wisconsin residents may subtract from federal adjusted gross income any interest included therein that is exempt from state taxation under

federal law. Sec. 71.05(6)(b)1, Wis. Stats. (1991-92).

A rule promulgated by the Wisconsin Department of Revenue lists a number of federal and state securities, the interest on which is excludable from the Wisconsin income of individuals and fiduciaries. Rule sec. Tax 3.095, Wis. Adm. Code. "Federal securities" that are exempt from tax ("Federal Securities") are defined as "securities which are direct and primary obligations of the United States and securities the interest of which federal law prohibits states from taxing." In addition to direct obligations of the United States Treasury, the listed securities include bonds issued by Guam (Rule sec. Tax 3.095(2)(t)), Puerto Rico (Rule sec. Tax 3.095(2)(z)), various agencies and political subdivisions of Puerto Rico (Rule sec. Tax 3.095(2)(x) through (zh)), and the U.S. Virgin Islands (Rule sec. Tax 3.095(2)(zq) and (zr)).

In addition, the same rule lists certain bonds issued by agencies or political subdivisions of the State of Wisconsin, the interest on which is exempt from the Wisconsin personal income tax. These include certain higher education bonds issued by the State of Wisconsin, certain bonds issued by the Wisconsin Housing and Economic Development Authority, Wisconsin Housing Finance Authority bonds, and public housing authority bonds and redevelopment authority bonds issued by Wisconsin municipalities. Rule sec. Tax 3.095(4)(b) through (e) and (g) through (h). (These bonds will be referred to collectively as "Exempt Wisconsin Bonds.")

Neither the statutes nor the rule state specifically whether interest on Federal Securities and Exempt Wisconsin Bonds is exempt from the Wisconsin personal income tax when received by taxpayers in the form of dividends

from a mutual fund investing in such securities. This question has been answered, however, in the case of U.S. Treasury securities, in *Capital Preservation Fund, Inc. v. Wisconsin Department of Revenue*, 145 Wis. 2d 841, 429 N.W.2d 551 (Ct. App. 1988). There, the Wisconsin Court of Appeals held that dividends paid by a mutual fund attributable to interest earned by the fund on direct obligations of the U.S. government were exempt from the Wisconsin personal income tax. The Court's holding was based on 31 U.S.C. § 3124(a), which generally prohibits states from imposing an income tax on interest on U.S. government obligations.

Although the decision in *Capital Preservation Fund* did not address the taxation of interest on obligations of U.S. territories and possessions, the holding of that case has been extended to such interest income, since such interest is exempted from state taxation under federal statutory provisions comparable to 31 U.S.C. § 3124(a). The department has set forth this position in the instructions for the 1992 individual income tax forms. Furthermore, the form instructions also confirm that the pass-through exemption treatment allowed for U.S. Treasury securities in *Capital Preservation Fund* also applies to Exempt Wisconsin Bonds.

In summary, the flow-through of tax-exempt status to shareholders of a mutual fund applies to all interest which either (1) federal law specifically prohibits states from taxing, or (2) Wisconsin law specifically provides as tax-exempt.

- II. Exclusion From Wisconsin Alternative Minimum Taxable Income of Mutual Fund Dividends Attributable to Interest on U.S. Bonds, Bonds Issued by U.S. Possessions and Territories, and Exempt Wisconsin Bonds

Wisconsin imposes an alternative minimum tax ("AMT") on individuals, trusts, and estates whose regular tax liability, as computed under sec. 71.02, Wis. Stats. (1991-92), is less than their AMT as computed under sec. 71.08, Wis. Stats. (1991-92). Wisconsin alternative minimum taxable income ("AMTI") is computed by starting with federal AMTI as defined in IRC sec. 55(b)(2). Generally, federal AMTI does not include interest on municipal bonds (including bonds issued by U.S. possessions and territories) because such interest is excludable from federal gross income under IRC sec. 103(a) and is not required to be added back to federal AMTI (with one exception discussed below).

Section 71.08(1)(a), Wis. Stats. (1991-92), provides that, with some exceptions, federal AMTI is to be adjusted by the adjustments provided by sec. 71.05(6) to (21), Wis. Stats. (1991-92) - the same adjustments that

are made to federal adjusted gross income in calculating Wisconsin regular taxable income. The only relevant adjustment is the adjustment under sec. 71.05(6) (b)1, Wis. Stats. (1991-92), which requires the subtraction of interest on U.S. government obligations.

Federal adjusted gross income does not include interest on bonds issued by U.S. possessions and territories or Exempt Wisconsin Bonds, and no adjustments are required by sec. 71.05(6) to (21), Wis. Stats. (1991-92), to add such income to federal AMTI when computing Wisconsin AMTI.

In one narrow category of cases, federal AMTI does include interest paid on municipal bonds. This category is that of "specified private activity bonds" issued by states or by U.S. territories and possessions, the interest on which is defined as an item of tax preference under IRC

sec. 57(a)(5). IRC sec. 57(a)(5)(B) also provides that, under regulations to be prescribed by the Secretary of the Treasury, any "exempt-interest dividends" paid by a mutual fund under IRC sec. 852(b)(5)(A) will be treated for this purpose as interest on a specified private activity bond to the extent it is paid from interest earned by the mutual fund on such a bond.

However, under sec. 71.08(1)(b), Wis. Stats. (1991-92), the interest on "specified private activity bonds" under IRC sec. 57(a)(5) is subtracted from the federal AMTI that is used to compute Wisconsin AMTI. Therefore, even if any bond issued by a U.S. territory or possession or Exempt Wisconsin Bond held by the Fund were considered to be a "specified private activity bond" under IRC sec. 57(a)(5), the interest on such a bond would not be included in Wisconsin AMTI. □