



301 Gervais Street, P.O. Box 125, Columbia, South Carolina 29214

SC PRIVATE LETTER RULING #93-8

TO: XYZ

SUBJECT: Taxation of Trust Fund
(Income Tax)

DATE: December 13, 1993

REFERENCES: Internal Revenue Code §852(b)(5)
Internal Revenue Code §103(a)
SC Code of Laws Ann. §12-7-430(b) (Supp. 1992)

AUTHORITY: S.C. Code Ann. §12-4-320 (Supp. 1992)

SCOPE: A Private Letter Ruling is a document issued by the Department of Revenue to a specific person.

NOTE: A Private Letter Ruling may only be relied upon by the person to whom it is issued and only for the transaction or transactions to which it relates. A Private Letter Ruling has no precedential value.

Questions:

1. Will shareholders who are
 - (a) individuals domiciled in South Carolina, or
 - (b) estates and trusts taxed under Subchapter J of the Internal Revenue Code and administered in South Carolinabe subject to South Carolina income tax on distributions from the ABC Fund which are exempt-interest dividends as defined in Internal Revenue Code Section 852(b)(5)?
2. Will
 - (a) individuals domiciled in South Carolina, or

(b) estates and trusts taxed under Subchapter J of the Internal Revenue Code and administered in South Carolina

holding shares of the ABC Fund for investment purposes be subject to South Carolina income tax on distributions of capital gain dividends as defined in Section 852(b)(3)(C) of the Internal Revenue Code?

3. Will distributions with respect to the ABC Fund attributable to proceeds of insurance paid to the ABC Fund that represent maturing or matured interest on defaulted obligations held by the Portfolio be subject to South Carolina income tax if, and to the extent that, such distributions are exempt interest dividends for federal income tax purposes pursuant to Section 852(b)(5) of the Internal Revenue Code?

Conclusions:

Issue 1: Individuals domiciled in South Carolina and estates and trusts taxed under Subchapter J of the Internal Revenue Code and administered in South Carolina who are shareholders will not be subject to South Carolina income tax on distributions from the ABC Fund which are exempt-interest dividends as defined in Internal Revenue Code Section 852(b)(5) provided that such dividends are attributable to obligations of South Carolina, its political subdivisions, the United States or its territories. (See SC Revenue Ruling 91-15 for a more detailed listing of obligations which are exempt from South Carolina income taxation.)

Issue 2: Individuals who are domiciled in South Carolina and estates and trusts taxed under Subchapter J of the Internal Revenue Code which are administered in South Carolina who hold shares of the ABC Fund for investment purposes will be subject to South Carolina income tax on distributions of capital gain dividends.

Issue 3: Distributions which are attributable to insurance proceeds paid to the Portfolio and distributed to the ABC Fund which represent maturing or matured interest on defaulted obligations held by the Portfolio are exempt from South Carolina income taxation to the extent they are considered exempt-interest dividends for federal income tax purposes and are attributable to obligations which are exempt from South Carolina income taxation.

Facts:

XYZ (the "ABC Fund"), is a series of the XYZ Trust. This trust is a business trust established pursuant to Massachusetts law and operates as a mutual fund (i.e., an open-end management investment company). The ABC Fund has one class of shares of beneficial interests (the "Shares"), and an unlimited number which may be issued by its trustees. Each Share represents an equal proportion of beneficial interest in the South Carolina Fund.

The ABC Fund will invest primarily in the South Carolina Tax Free Portfolio (the "Portfolio") which is organized as a common law trust and which will be treated and characterized as a partnership for federal and South Carolina income tax purposes. The Portfolio will invest in debt obligations issued by or on behalf of the State of South Carolina and its political subdivisions

and by the governments of Puerto Rico, the U.S. Virgin Islands and Guam. The interest on each issue of obligations held or to be held by the Portfolio will be excluded from gross income for federal income tax purposes under Section 103(a) of the Internal Revenue Code of 1986, as amended. The ABC Fund and the Portfolio will declare distributions of net investment income daily and pay distributions to holders of its shares on a monthly basis. Distributions by the ABC Fund will consist of exempt-interest dividends as defined in Internal Revenue Code Section 852(b)(5) or capital gain dividends as defined in Internal Revenue Code Section 852(b)(3)(C), or represent maturing or matured interest on defaulted obligations held by the Portfolio which are exempt-interest dividends for federal income tax purposes pursuant to Internal Revenue Code Section 852(b)(5).

The ABC Fund (a) will be treated as a “regulated investment company” within the meaning of Section 851 of the Internal Revenue Code and will qualify as such for each taxable year, (b) will take all other actions required to insure that no federal income taxes will be payable by the ABC Fund, and (c) will pay to shareholders “exempt-interest dividends” within the meaning of Section 852(b)(5) of the Internal Revenue Code. At all times, at least fifty percent of the value of the total assets of the Portfolio will consist of the obligations listed above.

Discussion – Issue 1:

South Carolina has adopted sections of the Internal Revenue Code, including IRC Sections 852 and 103. IRC Section 852(b)(5) states that certain dividends paid which are attributable to exempt interest are not taxable. IRC Section 103(a) provides that gross income does not include interest on any state or local bond. S.C. Code Section 12-7-430(b) states that South Carolina gross income is computed as provided in the Internal Revenue Code with certain modifications:

- (1) The exclusion from gross income authorized by Internal Revenue Code Section 103 is modified to exempt only interest upon obligations of this State, any of its political subdivisions, and to exempt interest upon obligations of the United States.

In SC Revenue Ruling 91-15 the Department held that the following are exempt from South Carolina income tax:

- 1) Interest from obligations issued by the State of South Carolina or any of its political subdivisions which are exempt from federal income taxes;
- 2) Interest from obligations which are issued by federal agencies or instrumentalities and contain language in their enabling legislation prohibiting the levying of a state or local tax on the interest from such obligations; and,
- 3) Interest from obligations of the United States which are characterized by:
 - a. Written documents,
 - b. The bearing of interest,

- c. A binding promise by the United States to pay specified sums at specified dates, and
- d. Specific Congressional authorization, which also pledged the faith and credit of the United States in support of the promise to pay.

The ruling also listed interest from obligations issued by Guam, Puerto Rico, and the U.S. Virgin Islands as exempt from South Carolina income tax.

The ruling further stated that a fund need not be invested 50% or greater in exempt obligations in order for the taxpayer to receive pass-through treatment for the dividends received. If only a portion of a mutual fund is invested in exempt obligations, the portion of dividends received which is attributable to such obligations is exempt for South Carolina income tax purposes. (See SC Revenue Ruling 91-15 for a more detailed discussion of which obligations are considered exempt from South Carolina income tax.)

Since the Portfolio constitutes and is characterized as a partnership for federal and South Carolina income tax purposes, the character of Fund income will depend upon the Fund's distributive share of the various types of the Portfolio's income. Therefore, the Fund will be exempt from South Carolina income taxation to the extent its distributable share of Portfolio income is attributable to exempt-interest dividends as defined in IRC Section 852(b)(5).

Discussion – Issue 2:

As mentioned above, South Carolina gross income is computed as provided in the Internal Revenue Code with certain modifications provided in SC Code Section 12-7-430. IRC Section 852(b)(3)(C) defines a capital gain dividend as “any dividend, or part thereof, which is designated by the company as a capital gain dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year”. Capital gain dividends are treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than 1 year (IRC Section 852(b)(3)(B)). There is no provision which exempts capital gain income from taxation; hence, capital gain dividends on shares held for investment by South Carolina domiciliaries are subject to South Carolina income taxation.

Discussion – Issue 3:

As discussed above in Discussion 1, exempt-interest dividends, to the extent they represent interest on South Carolina obligations, its political subdivisions or on obligations of the United States or its territories, are exempt from South Carolina income taxation. Hence, to the extent distributions attributable to insurance proceeds paid to the Portfolio which represent matured or maturing interest on defaulted obligations held by the Portfolio are deemed exempt-interest dividends for federal income tax purposes, and represent interest on obligations which are exempt from South Carolina income tax, such distributions will be considered exempt for South Carolina income tax purposes. (See Revenue Ruling 76-78 (1976-1 CD25).)