

Administrative Release No. 5

Subject: Mutual Fund Distributions of Tax-Exempt Interest and Capital Gains from State and Local Obligations

I. General

This release relates to the taxation of dividends and capital gains that taxpayers receive from investing in sales of mutual funds, which in turn invest in state and local obligations. What follows is a brief explanation of the federal law on the taxation of mutual funds and an explanation of Maryland law where it differs from federal law.

II. Federal Law

Regulated investment companies (mutual funds) that invest in tax-free municipal bonds (state and local) are permitted to pass the tax-free treatment on the bond interest to their shareholders when that interest is distributed.

A qualifying mutual fund is one that has at least 50% of the value of its total assets invested in tax-exempt municipal bonds at the close of each quarter of its taxable year. Additionally, the fund must pay out annually at least 90% of its net tax-exempt interest and designate the amount as a tax-free dividend in a notice to its shareholders within 60 days after the close of the fund's taxable year.

The Internal Revenue Code allows shareholders of a qualifying mutual fund to exclude from income tax-exempt interest that is distributed to them by the fund because the tax-exempt character of the interest passes through to the shareholders. Because the interest is not subject to tax, shareholders may not claim a deduction for interest paid on indebtedness used to purchase or carry mutual fund shares.

Any capital gain realized from the sale of a state or local obligation is taxable at the individual level, and the gain flows through to the Maryland return.

III. Maryland Law

A. Tax-exempt interest

Under Section 10-204(b) of the Tax-General Article, interest on obligations of states other than Maryland and their subdivisions, flowing through from the mutual fund as a dividend, must be added to federal adjusted gross income. Any flow through

of interest on obligations and securities of the State of Maryland and its political subdivisions is not taxable and, therefore, does not have to be added to federal adjusted gross income on the Maryland return.

Although taxpayers are not required to attach a statement to their returns, the Revenue Administration Division may ask the taxpayer or fund to verify and substantiate the nature and the identity of the state and local securities which are the basis for the tax exemption on the Maryland return.

B. Capital gains included in dividends

The Tax-General Article, Section 10-207(i), provides for subtracting from federal adjusted gross income, to the extent included, the amount of any profit realized from the sale or exchange of a bond issued by the State of Maryland or political subdivision of the State of Maryland. Therefore, if a dividend from a mutual fund includes the profit or gain from the sale of a Maryland state or local obligation, this gain is excluded from taxation on the Maryland return. Profit or gain realized from the sale of other state or local obligations is taxable.

C. Capital gains from the sale of mutual funds shares

Capital gains realized from the sale of shares in a mutual fund are subject to Maryland tax. In this respect, Maryland law follows federal law and the capital gains portion flows through from the federal return to the Maryland return without modification.

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