

TAXATION (INCOME): (1) A corporation whose only activity  
TAXATION (EXEMPTIONS): is the investment or reinvestment of its  
own funds in securities which are obligations of the United States Government or its instrumentalities is not subject to Missouri Income Tax by reason of the provisions of Section 143.040.1, RSMo 1969, and the income thereof is exempt under Section 143.150(5), RSMo 1969. (2) Dividends paid to stockholders of the corporation described in (1) are to be included in taxable income under the provisions of Section 143.100, RSMo 1969.

October 28, 1970

OPINION NO. 389

Honorable Philip H. Snowden  
Representative - District 86  
313 Armour Road  
North Kansas City, Missouri 64116



Dear Representative Snowden:

This official opinion is rendered pursuant to the request contained in your letter concerning the taxation of an open-end diversified investment company and its stockholders under the Missouri Income Tax Law.

More specifically the questions presented are (1) whether a regulated investment company as defined in the Internal Revenue Code is exempt from the Missouri Income Tax by reason of Section 143.040, RSMo 1969, and, (2) whether dividends paid to the stockholders of a regulated investment company from undistributed profits or earnings, the source of which is interest on obligations of the United States, are taxable under the Missouri Income Tax Law.

The pertinent facts as set forth in the request and the prospectus filed with the Securities and Exchange Commission are as follows:

Mutual Fund for Investing in U. S. Government Securities, Inc., was incorporated under the laws of the State of Maryland in 1969. It maintains its principal office in Pittsburgh, Pennsylvania. Certain of the shares of the corporation are owned by residents of Missouri and while it is not clear whether the corporation is doing business in Missouri, such fact is assumed for the purpose of this opinion.

The primary purpose or objective of the Fund is to receive current income from its investments and its investments are limited to

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securities which are obligations of the United States Government or its instrumentalities. The Fund was organized and is being operated in such manner as to meet the requirements of the Internal Revenue Code applicable to regulated investment companies and thereby to receive the special federal income tax treatment afforded to such companies. The corporation distributes its earnings or profits to its shareholders by declaration and payment of dividends.

A regulated investment company, as defined in Section 851(a) of the Internal Revenue Code of 1954 and the Investment Company Act of 1940, as amended, 54 Stat.789 (1940); 15 U.S.C. 80a-1 to 80b-2 (1940) is an issuer of any security and which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities.

While it is recognized that the federal statutes do not control the taxation of such corporations under the state law, the statutes of Missouri contain a provision which excludes from the income tax corporations whose activities are of the type involved in the present case.

Section 143.040.1, RSMo 1969, in pertinent part provides as follows:

" \* \* \* a tax shall be levied upon, assessed against, collected from, and paid by every corporation, \* \* \* licensed to do business in this state, or doing business in this state, \* \* \* except corporations whose only activity is the investment or reinvestment of its own funds in stocks, bonds, any other securities, \* \* \* in such percent, as now or hereafter provided, of the net income from all sources in this state during the preceding year. \* \* \* "

Section 143.030.2, RSMo 1969, states:

"The rate of two percent of net income is hereby declared and provided as the rate or percent of net income levied and assessed by, and as applicable to sections 143.040 to 143.080."

The express provisions of the statute made an exception of corporations whose activities are of the same character as those of the regulated investment company involved here.

In addition to the exception provided in Section 143.040, the income received by this corporation would not be subject to Missouri income tax by reason of Section 143.150, RSMo 1969, which provides:

"The following income shall be exempt from the provisions of this chapter:

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\* \* \*

"(5) Interest upon the obligations of this state or any political subdivision thereof, or upon the obligations of the United States or its possessions."

Based upon the language of the statute, therefore, it is our view that the corporation here in question is not subject to the income tax imposed by the State of Missouri.

The second question raised by your letter relates to the taxable character of dividends received by stockholders of the corporation considering the fact that the entire source of corporate income is yield from United States Government obligations.

As indicated above, Section 143.150 exempts from the income tax "Interest \* \* \* upon the obligations of the United States \* \* \* ". In the present case the interest income is paid by the United States Government to the corporation and when paid it becomes a part of the current earnings or undistributed profits of the corporation although because of the exemption such interest would not be included in taxable net income. The earnings or profits of the corporation are the source from which dividends are paid to the stockholders. There is no payment of interest by the United States Government to the stockholders. There is a distribution of earnings or profits of the corporation to the stockholders by way of dividend payments. It is the interest paid by the United States Government to the corporation which carries the tax exemption; there is no exemption of amounts received by stockholders from earnings or profits of the corporation.

Under both the federal statutes and the Missouri law, dividends paid from earnings or profits of a corporation are taxable to the shareholder. Section 143.100.2, RSMo 1969, defining income subject to tax, in pertinent part, states as follows:

"2. 'Income' shall also include interest, rent, dividends, securities and gains, profits and earnings from any other transactions of any business carried on for gain or profit; and from any sources whatever; \* \* \* "

The only basis for holding the dividends received to be exempt from tax is to assume that the United States Government bond interest constituted income of the stockholders rather than the corporation. In other words, the corporation is a mere conduit through which such interest passed from the government to the stockholders. We do not believe the conduit principle is properly applied to the factual situation involved here.

It has been authoritatively stated that in general, income exempt from tax received by a corporation loses its character as such and becomes part of the earnings and profits of the corporation taxable as a dividend upon distribution to the stockholders. It is immaterial

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that a separate account is being kept of such income or even that it is placed in a separate bank account. This rule is of particular importance in the case of tax exempt interest. This interest, although exempt from income tax when received by the corporation, nevertheless forms part of its earnings and profits and hence a source of taxable dividends. Law of Federal Income Taxation, Mertens, Vol. 1, Sec.9.32; Ayer v. Commissioner, 12 B.T.A.284; Wilson v. Commissioner, 31 B.T.A. 1022; Weyerhaeuser v. Commissioner, 33 B.T.A. 594; United National Corporation 2 T.C.111.

In the Weyerhaeuser case, supra, it was said:

" \* \* \* Again, many items, such as interest upon the obligations of a state or political subdivision, tax-free federal securities, and dividends from other corporations, must necessarily be considered in computing earnings and profits, though forming no part of taxable net income."

Likewise in Ayer v. Commissioner, supra, the Board of Tax Appeals said:

"This is not the only case where some income or profit free from tax in the hands of a corporation is, nevertheless, taxable to a stockholder upon distribution. Dividends and stock of domestic corporations, interest on bonds and obligations of states and municipalities, and statutory exemptions are not a part of the statutory net income of a corporation, but are nevertheless a part of its earnings or profits and may form a part of ordinary dividends which are taxable when received by the stockholders. \* \* \* "

In United National Corporation, 2 T.C.111,123, the court said:

"The tax free profit realized upon the redemption of the preferred stock is taxable to a stockholder upon distribution, just as tax free interest on exempt bonds is part of earnings and profits and may form part of ordinary dividends which are taxable when received by stockholders. \* \* \* "

Although these cases arose under federal income tax statutes, it is apparent the same principle is applicable under the Missouri law. The concept of dividends under the Missouri statute is sufficiently broad to include any distribution from earnings or profits.

It is our further opinion that the fact the corporation here is a regulated investment company under the federal law rather than an ordinary business corporation does not change the character of its distributions to stockholders. In this connection, the author, Lester W. Rubin, in an article entitled "Regulated Investment Companies," (8 Taxes 541) stated:

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"It is very seldom that regulated investment companies put their funds into tax-exempt state and municipal obligations. The rate of return is too low. But if interest were received from tax-exempt securities and were then paid out in the form of dividends, would these dividends be tax-exempt to the investment company shareholders? No specific authority seems to be available, at present, on this point, but qualified authorities in the investment company field who were consulted were of the opinion that no earmarking of dividends as tax exempt would be possible. If the company had a surplus, the dividends would be taxable, but if there were a deficit, the dividends would be a tax-free return of capital. According to this view, the 'conduit' principle does not apply."

We recognize there is little authority on the precise point. However, it is our opinion that the principle set forth in Mertens Law of Federal Income Taxation as supported by the cases cited therein, is properly applicable to the circumstances involved here.

CONCLUSION

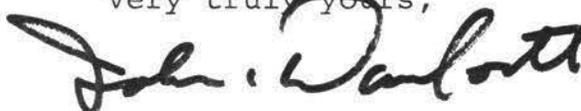
It is, therefore, the opinion of this office that:

(1) A corporation whose only activity is the investment or reinvestment of its own funds in securities which are obligations of the United States Government or its instrumentalities is not subject to Missouri Income Tax by reason of the provisions of Section 143.040.1, RSMo 1969, and the income thereof is exempt under Section 143.150(5), RSMo 1969.

(2) Dividends paid to stockholders of the corporation described in (1) are to be included in taxable income under the provisions of Section 143.100, RSMo 1969.

The foregoing opinion, which I hereby approve, was prepared by my assistant, John E. Park.

Very truly yours,



JOHN C. DANFORTH  
Attorney General