

STATE OF ALABAMA  
DEPARTMENT OF REVENUE,

§

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DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

§

v.

§

DOCKET NO. INC. 89-101

JAMES D. & PATRICIA M. HOLLAND§  
208 Shady Lane  
Enterprise, AL 36330,

§

Taxpayer.

§

ORDER

The Taxpayers, James D. & Patricia M. Holland, claim refund of income tax for the year 1986. The Department denied the refund and the Taxpayers appealed to the Administrative Law Division. A hearing was conducted in the matter on December 13, 1989. Mr. Leonard. Sharp represented the Taxpayers. Assistant counsel Mark Griffin appeared for the Department. A Recommended Order was entered on December 27, 1989. After review of the Administrative Law Record and the Recommended Order, the following Order is hereby entered.

FINDINGS OF FACT

The Taxpayers reported as taxable income on their 1986 Alabama income tax return a dividend of \$5,162.50 received from the Kemper Income and Capital Preservation Fund. The Taxpayers subsequently filed an amended 1986 return and claimed thereon that 39% of the Kemper Fund dividend should be exempt because it was derived from interest on U.S. Government obligations, see Code of Ala. 1975, §40-18-14(2)d. The Department denied the refund claimed on the amended return, and the Taxpayers appealed to the Administrative

Law Division.

In late 1983 or early 1984, the Income Tax Division of the Revenue Department requested an opinion from the Department's Legal Division concerning the taxability of dividend distributions from a regulated investment company where the dividends are derived from tax exempt interest on U.S. Government obligations. If received directly, such interest is exempt from Alabama income tax under §40-18-14(2)d.

An opinion was subsequently issued by the Legal Division on January 18, 1984 stating that such dividends should be exempt from Alabama income tax. The Legal Division opinion was based on 31 U.S.C. §3124, which exempts from state and local taxation all obligations and stocks of the U.S. Government, and all interest relating thereto.

The Income Tax Division concurred in the Legal Division opinion, but restricted its scope so that only dividend distributions consisting entirely of exempt government interest should be exempt. That is, if any part of the dividend is derived from any source other than exempt interest, then the Department considers the entire dividend to be taxable.

In the present case, the Taxpayers established at the administrative hearing that 42% (not 39% as indicated on the amended return) of the Kemper Fund dividend received in 1986 was derived from tax exempt U.S. Government obligations. However, the

Department denied any exemption based on its above-stated position that a dividend is not exempt unless the entire dividend is made up entirely of exempt interest income.

CONCLUSIONS OF LAW

Interest income from U.S. Government obligations is exempt from Alabama income tax by Code of Ala. 1975, §40-18-14(2)d. However, 31 U.S.C.A. 53124 is much broader in that it exempts from state and local taxes all stocks and obligations of the U.S. Government and all interest derived from such obligations.

The Legal Division opinion of January 18, 1984 correctly cites §3124 as authority for exempting dividend distributions from a regulated investment company if the dividends are made up of tax exempt government interest, see American Bank & Trust v. Dallas County, 103 S. Ct. 3369, 463 U.S. 855; and Memphis Bank and Trust Company v. Garner, 103 S. Ct. 692, 459 U.S. 392. Interest on government obligations should retain its exempt status when passed through a regulated investment company.

The Department's position is that the exemption should apply only if all of the dividend is derived from tax exempt interest.

However, there is no basis or authority for the Department's position. Rather, any portion of a distribution that a taxpayer can prove originated from interest from government obligations should be excluded from taxable income.

There is no question in the present case that 42% of the

Kemper Fund dividend received in 1986 was derived from interest on U. S. government obligations. A refund should be issued accordingly.

The final order may be appealed by the Taxpayers pursuant to Code of Ala. 1975, §41-22-20.

Entered this the 27th day of December, 1989.

JAMES SIZEMORE, Commissioner