

New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division

TSB-A-00(1)I
Income Tax
February 29, 2000

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. I991123A

On November 23, 1999, a Petition for Advisory Opinion was received from Fidelity New York Municipal Trust and its portfolio series Spartan New York Municipal Income Fund, 82 Devonshire Street, Boston, Massachusetts 02109.

The issue raised by Petitioners, Fidelity New York Municipal Trust (the “Trust”) and its portfolio series Spartan New York Municipal Income Fund (the “Fund”), is whether for New York State and City personal income tax purposes, exempt-interest dividends attributable to interest on New York municipal obligations and obligations of United States territories and possessions that are paid by mutual funds (the “lower-tier funds”) to another mutual fund (the “upper-tier fund”) that is similarly qualified to pay exempt-interest dividends, which are excluded from federal adjusted gross income, are also excluded from adjusted gross income for New York State and City personal income tax purposes when paid by the upper-tier fund to shareholders of the upper-tier fund who are subject to the New York State or City personal income tax.

Petitioners submit the following facts as the basis for this Advisory Opinion.

Background

The Fund is a portfolio series of the Trust¹. The Fund qualified as a regulated investment company (“RIC”) under Subchapter M of the Internal Revenue Code of 1986, as amended (“IRC”), in its most recent taxable year ended January 31, 1999, and intends to continue to qualify as such in all subsequent years. The Fund is treated as a separate corporation for federal income tax purposes pursuant to section 851(g) of the IRC. The Fund invests predominately in obligations of New York municipal issuers and United States territories and possessions, which obligations pay interest that is exempt from federal and New York State and City income tax (“New York Exempt Obligations”). The Fund has qualified and expects to continue to qualify to pay exempt-interest dividends excludable from federal adjusted gross income under section 852(b)(5) of the IRC (“Federal Exempt-Interest Dividends”), which dividends will be largely or entirely exempt from New York State and City income tax under section 612 of the Tax Law and section 11-1712 of the New York City Administrative Code, respectively.

¹ The Trust is organized as a Massachusetts business trust and is registered as an open-end management investment company under the Investment Company Act of 1940, as amended, 15 USC 80a-1 *et seq.* (The “1940 Act”). The Trust is also a “series company” under Rule 18f-2 of the 1940 Act.

The principal office of the Fund is located at 82 Devonshire Street, Boston, Massachusetts 02109. The Fund has an investment management agreement with Fidelity Management & Research Company (“Fidelity”) and a sub-advisory agreement with an affiliated sub-advisor.

As a New York municipal income fund, the Fund seeks a high level of current income exempt from federal income tax and New York State and City personal income tax. Specifically, one of the Fund’s principal investment strategies is to invest so that normally at least 80 percent of its income distributions are exempt from federal and New York State and City personal income tax.² In selecting the Fund’s investments, Fidelity uses the Lehman Brothers New York 4 Plus Year Municipal Bond Index (the “Index”) as a guide. Fidelity’s strategy for the Fund is to have an overall interest-rate risk which is comparable to the Index and to maintain the Fund’s dollar-weighted average maturity (“DWAM”) at a level that is reasonably close to the DWAM of the Index. As of January 31, 1999, the DWAMs of the Fund and the Index were 13.7 years and 15.65 years, respectively.

Need to Invest in Short-Term Securities

Although the DWAM of the fund frequently exceeds 10 years, the Fund must maintain an adequate position in short-term securities for purposes of maintaining sufficient liquidity. Because the Fund is “open-end”, investors have the right to purchase and redeem Fund shares at any time. As a result, the fund may need cash in certain circumstances to fund unexpected shareholder redemptions. Short-term investments, which mature frequently, provide a source of proceeds to satisfy unexpected redemptions by shareholders. By staggering short-term investments so that a certain portion matures every day, the Fund can ensure a ready supply of cash. Cash that is not used to finance redemptions can be “rolled over” into new short-term investments. Such an approach would not be feasible with long-term securities, which mature over a more extended period.

Although short-term investments are, therefore, extremely important to the Fund, there is a limited supply of such investments that the Fund may purchase. There are numerous types of short-term fixed-income investments. Many of the most popular of these investments, however, such as repurchase agreements, overnight commercial paper and overnight bank time-deposits, pay interest that is subject to both federal and state income tax. The Fund cannot purchase such instruments due to (a) the Fund’s investment objective to seek a high level of current income exempt from federal and New York State and City income tax and (b) the Fund’s policy not to invest in municipal

² Under a proposal on which the Fund’s shareholders are scheduled to vote on February 16, 2000, this strategy would be modified so that the Fund would be required to invest at least 80 percent of its assets in municipal securities whose interest is exempt from federal and New York State and City personal income taxes. This shift from an income-distribution-based strategy to an asset-based strategy is intended to facilitate compliance monitoring, since asset-based limits generally can be monitored more efficiently.

securities whose interest is subject to federal income tax. As a result, the Fund's preferred option for short-term investments is to invest in obligations issued by New York municipalities. Unfortunately, in many cases such obligations may be in short supply.

Alternative Investments

In order to alleviate these problems, Fidelity is planning to allow the Fund to invest in one or more money market funds that it manages in lieu of, or in addition to, having the Fund invest directly in short-term securities. Money market funds are governed by an extensive set of rules set forth in Rule 2a-7 (17 CFR §270.2a-7) under the 1940 Act and differ from other types of mutual funds in that they seek to maintain a stable net asset value, typically \$1.00 per share.

Two of the specific money market funds in which the Funds may invest are the Spartan New York Municipal Money Market Fund and Fidelity New York Municipal Money Market Fund (collectively, the "New York Retail Funds"), which are available to the public. Each of the New York Retail Funds is organized as a portfolio series of a Delaware business trust, is taxable as a separate corporation for federal income tax purposes under section 851(g) of the IRC, and has qualified and expects to continue to qualify as a RIC under Subchapter M of the IRC. Each of the New York Retail Funds also has qualified and expects to continue to qualify to pay Federal Exempt-Interest Dividends which dividends will be largely or entirely exempt from New York State and City income tax pursuant to section 612 of the Tax Law and section 11-1712 of the New York City Administrative Code. As of October 29, 1999, 95.7 percent of Fidelity New York Municipal Money Market Fund's net assets and 95.4 percent of Spartan New York Municipal Money Market Fund's net assets consisted of New York Exempt Obligations.

Discussion

Section 612(a) of the Tax Law provides that the New York adjusted gross income of a resident individual means the individual's federal adjusted gross income as defined in the laws of the United States for the taxable year, with the modifications specified in section 612 of the Tax Law.

Section 62 of the IRC provides that, for federal income tax purposes, adjusted gross income means gross income less certain deductions.

Section 103(a) of the IRC, with certain exceptions, provides that gross income does not include interest on any state or local bond. Section 1.103-1(a) of the Treasury Regulations provides that interest upon obligations of a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof is not includible in gross income, except as provided under section 103(c) and(d) of the IRC.

Exempt-interest dividends are paid by a RIC pursuant to section 852(b)(5) of the IRC. Section 852(b)(5)(B) of the IRC states that “[a]n exempt-interest dividend shall be treated by the shareholders for all purposes of this subtitle as an item of interest excludable from gross income under section 103(a). Such purposes include but are not limited to – (i) the determination of gross income and taxable income ...” If all of the other requirements of section 852 of the IRC have been met, section 852(b)(5) of the IRC provides that a RIC may pay exempt-interest dividends if, as the close of each quarter of its taxable year, at least 50 percent of the value of the total assets of the RIC consist of obligations described in section 103(a) of the IRC. An exempt-interest dividend paid must be designated as such in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year.

Therefore, the amount of exempt-interest dividends issued by a RIC that is excluded from a shareholder’s federal gross income pursuant to section 103(a) and 852(b)(5) of the IRC, is excluded from federal adjusted gross income, the starting point in computing the shareholder’s New York adjusted gross income.

Likewise, where a RIC meets all of the requirements of section 852 of the IRC and pays exempt-interest dividends pursuant to section 852(b)(5) of the IRC to a shareholder that is another RIC, and that other RIC also meets all the requirements of section 852 of the IRC, and also pays exempt-interest dividends pursuant to section 852(b)(5) of the IRC to shareholders who are subject to New York personal income tax, the amount of such exempt-interest dividends received by a shareholder is excluded from the shareholder’s federal gross income pursuant to section 103(a) and 852(b)(5) of the IRC. Such exempt-interest dividends are also excluded from the shareholder’s federal adjusted gross income, the starting point for computing the shareholder’s New York adjusted gross income.

When computing New York adjusted gross income, the only modification contained in section 612 of the Tax Law that affects the shareholders of a RIC that pays exempt-interest dividends is section 612(a) which provides an add modification for the portion of such exempt-interest dividends derived from obligations of any state, other than New York, or a political subdivision of any such other state, to the extent not includible in federal adjusted gross income.

Section 612(b)(1) of the Tax Law provides that when computing New York adjusted gross income a taxpayer shall add to federal adjusted gross income “interest income on obligations of any state other than this state, or of a political subdivision of any such other state ... to the extent not properly includible in federal adjusted gross income.” There is no such add modification required for interest income from obligations of the State of New York, its political subdivisions or of possessions or territories of the United States. Exempt-interest dividends issued by a RIC constitute interest for the purposes of section 612 of the Tax Law. Municipal Fund for Temporary Investment, Inc., Adv Op of Commn T&F, July 18, 1980, TSB-H-(245)I.

Section 112.2(a) of the New York State Personal Income Tax Regulations provides:

Interest income on obligations of any state, other than New York State, or of a political subdivision of any such other state (including that part of an exempt-interest dividend, as described in section 852(b)(5)(B) of the Internal Revenue Code, paid by a regulated investment company which is derived from any such obligations), unless created by compact or agreement to which New York State is a party, to the extent not properly includible in Federal adjusted gross income.

Accordingly, if for federal income tax purposes, a shareholder of a RIC receives exempt-interest dividends derived from New York municipal obligations and obligations of United States territories and possessions that are excluded from the shareholder's federal adjusted gross income, such exempt-interest dividends are excluded from New York adjusted gross income. (See, Franklin New York Tax-Exempt Money Fund, Adv Op Comm T&F, December 30, 1991, TSB-A-91(11)I)

Section 11-1712(a) and (b)(1) of the New York City Administrative Code are identical to section 612(a) and (b)(1) of the Tax Law. Therefore, for a shareholder of a RIC subject to the New York State and City personal income tax, the principles described and the conclusion reached herein, for New York State personal income tax purposes, will also apply to the application of the New York City personal income tax.

Conclusion

For New York State and City personal income tax purposes, exempt-interest dividends attributable to interest on New York municipal obligations and obligations of United States territories and possessions that are paid by the lower-tier funds to an upper-tier fund that is similarly qualified to pay exempt-interest dividends, which are excluded from federal adjusted gross income, are also excluded from New York adjusted gross income when paid by the upper-tier fund to shareholders of the upper-tier fund who are subject to New York State or City personal income tax.

DATED: February 29, 2000

/s/
John W. Bartlett
Deputy Director
Technical Services Division

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.