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# FEDERAL AND STATE TAXATION OF MUNICIPAL BOND MUTUAL FUNDS: A PROPOSAL FOR A PRINCIPLED STATE RESPONSE TO AMENDMENTS TO THE CODE

## INTRODUCTION

Section 2137 of the Tax Reform Act of 1976<sup>1</sup> amended section 852(b) of the Internal Revenue Code<sup>2</sup> to permit the shareholders of a qualified<sup>3</sup> regulated investment company<sup>4</sup> to treat a dividend paid by the company from interest on tax-exempt municipal bonds<sup>5</sup> — an “exempt-interest dividend” — as an item excludable from gross income.<sup>6</sup> The Amendment was designed to accomplish two objectives: (1) to broaden the municipal

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1. Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified throughout 26 U.S.C. (Cum. Supp. 1977)). Section 2137 of the Tax Reform Act of 1976 may hereinafter be referred to as the Amendment.

2. The Internal Revenue Code may hereinafter be referred to as the Code.

3. A regulated investment company is qualified to pay exempt-interest dividends to its shareholders if, at the close of each quarter of its taxable year, at least 50 percent of the value of its total assets consists of obligations described in I.R.C. § 103(a)(1). I.R.C. § 852(b)(5). For the text of I.R.C. § 103(a)(1), see note 5 *infra*.

4. For purposes of the Code, the term “regulated investment company” is defined in I.R.C. § 851(a). Throughout this Comment, all references to “investment companies” refer only to regulated investment companies as defined in the Code.

5. I.R.C. § 103(a) provides in pertinent part: “Gross income does not include interest on — (1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia . . . .” The term “municipal bond” is generally understood to include bonds issued by any of the governmental units described in I.R.C. § 103(a). Calvert, *An Introduction to Municipal Bonds*, in *FUNDAMENTALS OF MUNICIPAL BONDS* 1 (4th ed. G. Calvert ed. 1965).

6. The Amendment modified I.R.C. § 852(b) by inserting the following new paragraph:

(5) EXEMPT-INTEREST DIVIDENDS. — If, at the close of each quarter of its taxable year, at least 50 percent of the value (as defined in section 851(c)(4)) of the total assets of the regulated investment company consists of obligations described in section 103(a)(1), such company shall be qualified to pay exempt-interest dividends, as defined herein, to its shareholders.

(A) DEFINITION. — An exempt-interest dividend means any dividend or part thereof (other than a capital gain dividend) paid by a regulated investment company and designated by it as an exempt-interest dividend in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including exempt-interest dividends paid after the close of the taxable year as described in section 855) is greater than the excess of —

(i) the amount of interest excludable from gross income under section 103(a)(1), over

(ii) the amounts disallowed as deductions under sections 265 and 171(a)(2),

the portion of such distribution which shall constitute an exempt-interest dividend shall be only that proportion of the amount so designated as the

bond market and (2) to rectify an inconsistency in the provisions of the Code governing regulated investment companies.

The first part of this Comment will discuss the federal taxation<sup>7</sup> of regulated investment companies and the recent developments in the municipal bond market that led to the enactment of the Amendment. Although similar legislation was proposed as early as 1955, the support needed to pass such legislation did not develop until the capacity of the municipal bond market to continue providing state and local governments with needed capital became a matter of Congressional concern. This concern provided an impetus for Congress to pass legislation enabling regulated investment companies to enter the troubled municipal bond market.

The second part of this Comment will consider the effect of the Amendment on a state income tax that is based on a federal income tax figure. Many states have incorporated portions of the Internal Revenue Code into their income tax laws.<sup>8</sup> While the manner and extent of incorporation vary widely among the states, in general three basic approaches have been adopted.<sup>9</sup> A few states assess a fixed percentage of the taxpayer's federal tax liability,<sup>10</sup> and some use federal taxable income or gross income as the state income tax base.<sup>11</sup> Most of the states using a federal income tax figure as a starting point for the computation of state income tax liability have adopted federal adjusted gross income as the point of departure.<sup>12</sup>

Whenever the Internal Revenue Code is amended, a state income tax will thereby be altered to the extent that the state has incorporated the provisions of the Code affected by the amendment. Under the laws of Maryland, the definition of taxable net income is "federal adjusted gross income as defined in the laws of the United States, as amended from time to

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amount of such excess for such taxable year bears to the amount so designated.

(B) TREATMENT OF EXEMPT-INTEREST DIVIDENDS BY SHAREHOLDERS. —

An 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)(1). Such purposes include but are not limited to —

- (i) the determination of gross income and taxable income,
- (ii) the determination of distributable net income under subchapter J,
- (iii) the allowance of, or calculation of the amount of, any credit or deduction, and
- (iv) the determination of the basis in the hands of any shareholder of any share of stock of the company.

7. All references to taxation refer only to personal income taxation and not to taxation of corporations.

8. As of January 1978, 34 states had adopted a federal income tax figure as the state income tax base. See STATE TAX GUIDE (CCH) 1542.

9. Walthall, *Alabama Income Tax Law — A Need For Revision*, 28 ALA. L. REV. 274, 274 (1977).

10. See, e.g., VT. STAT. ANN. tit. 32. § 5822 (1970).

11. See, e.g., MASS. ANN. LAWS ch. 62, § 2 (Michie/Law. Co-op.) (Cum. Supp. 1977) (federal gross income); UTAH CODE ANN. § 59-14A-11 (1974) (federal taxable income).

12. [1977] 38 STATE TAX REVIEW (CCH) no. 48, at 2. See generally MD. ANN. CODE art. 81, § 280(a) (1975); MONT. REV. CODES ANN. § 84-4905 (Supp. 1977).

time and in effect for the corresponding taxable year, with the modifications and less the deductions and personal exemptions provided in this subtitle.”<sup>13</sup> Consequently, an amendment to the Internal Revenue Code that alters federal adjusted gross income will likewise alter Maryland taxable income,<sup>14</sup> unless either the amendment concerns a subject of taxation for which existing Maryland law provides for a modification to federal law or the Maryland legislature takes affirmative action to counteract the amendment. In some cases, the Maryland legislature has taken affirmative action to counteract the effects on the state income tax of an amendment to the Internal Revenue Code.<sup>15</sup> In most cases, including the recent amendment to section 852(b) of the Code, the legislature has not elected to take such action. It is not apparent whether the state legislature has based its decisions to conform or not to conform to federal amendments upon any particular standard. Indeed, it is not at all apparent whether the legislature has made such decisions consciously in every instance, or even in most instances.

However, in order for Maryland or any state with a federally-based income tax to develop and maintain a rational, coherent, and equitable state income tax system, the state legislature must evaluate every amendment to the Internal Revenue Code to determine whether conformity to the amendment is consonant with state tax policy. Such a determination will be made in the second part of this Comment by examining and evaluating the impact on the Maryland income tax of the recent amendment to section 852(b) of the Internal Revenue Code. In this examination, initial consideration will be given to the reasons for which the Amendment was enacted by Congress. Reference will then be made to the same principles of tax policy that have long been applied to federal income tax laws. This examination

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13. MD. ANN. CODE art. 81, § 280(a) (1975).

14. An amendment to the Code that does not affect federal adjusted gross income may nonetheless alter Maryland taxable income. For example, the Tax Reduction and Simplification Act of 1977, signed into law on May 23, 1977, provided that an individual is not permitted to itemize deductions in computing his federal income tax if such itemized deductions are less than the “zero bracket amount,” which is defined as \$3,200 in the case of married couples filing joint returns and \$2,200 in the case of single persons. Tax Reduction and Simplification Act of 1977, Pub. L. No. 95-30, § 102, 91 Stat. 126 (codified at 26 U.S.C. § 63 (Supp. I 1977)). Under existing Maryland law, only those who itemized their deductions on their federal income tax return were permitted to itemize their deductions on their state return. MD. ANN. CODE art. 81, § 281(a) (1975). As a consequence of the amendment to the Code, under the existing law many Maryland taxpayers would have been forced to use the Maryland standard deduction (10% of gross income up to a maximum of \$500) in computing their Maryland income tax for 1977. In effect, many Maryland taxpayers would have been subjected to an increase in the state income tax not intended by the legislature.

To avoid this consequence, emergency legislation was introduced to authorize Maryland taxpayers to itemize deductions for 1977 even though they used the standard deduction in computing their federal income tax. See Md. House Bill No. 1319 (Feb. 8, 1978). Separate bills have also been introduced to raise the Maryland standard deductions for future years and thus correct the problem. News Release No. A-16 from the Comptroller of the Treasury of Maryland (Feb. 3, 1978).

15. See, e.g., note 14 *supra*.

will offer states that have adopted a federal income tax figure as a state income tax base a model for determining whether conformity to an amendment to the Internal Revenue Code is desirable in a particular instance.

#### FEDERAL TAXATION OF MUNICIPAL BOND MUTUAL FUNDS

A regulated investment company, sometimes referred to as a "mutual fund,"<sup>16</sup> issues shares publicly to investors and invests the funds received in a diversified portfolio of securities selected and supervised by the company's investment managers.<sup>17</sup> An individual investor may choose either to invest directly in a security that is publicly traded or to invest indirectly through a regulated investment company that includes that security in its portfolio. Which form of investment the individual investor chooses will depend upon a weighing of the advantages offered by an investment company — in particular, diversification of risk and professional investment management — against the cost of these advantages and any substantial additional income tax burdens.<sup>18</sup>

The tax considerations are of special significance. In general, regulated investment companies represent an intermediate layer between the investor and the entities whose securities it acquires with its shareholders' funds.<sup>19</sup> This peculiar characteristic of regulated investment companies makes their viability largely dependent upon the kind of tax treatment to which they are

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16. HOUSE COMM. ON WAYS AND MEANS, 86TH, CONG., 1ST SESS., 3 TAX REVISION COMPENDIUM 1671 (Comm. Print 1959) (a compendium of papers submitted to the House Committee on Ways and Means on broadening the tax base) [hereinafter cited as 3 COMPENDIUM].

There are two basic types of regulated investment companies, closed-end and open-end. The two types of investment companies differ mainly with respect to capitalization and the manner in which shares of each are acquired and disposed of by investors. *Id.* The closed-end company normally has a fixed capitalization with a fixed number of shares outstanding which is only infrequently modified. Shares are traded on national securities exchanges, such as the New York Stock Exchange, or in the over-the-counter market. The open-end company, the type commonly referred to as a mutual fund, derives its name from the fact that the number of its outstanding shares is continuously changing. Unlike a closed-end investment company or a typical operating company, the capital of a mutual fund is in a constant state of flux as new shares are issued and redeemed daily. *Id.* at 1672. Mutual funds comprise by far the largest segment of the investment company industry. *Taxation of Interest on Debt Obligations Issued by State and Local Governments and on Withholding Federal Income Tax on Interest and Dividend Income: Hearing Before the Senate Comm. on Finance, 94th Cong., 2d Sess. 135 (June 7, 1976)* [hereinafter cited as *Comm. on Finance*] (statement of Edwin S. Cohen, app. II). Although the term "mutual fund" technically refers only to an open-end investment company, throughout this Comment the terms "mutual fund" and "regulated investment company" will be used interchangeably.

17. Clark, *The Federal Income Taxation of Financial Intermediaries*, 84 YALE L.J. 1603, 1623 (1975).

18. 3 COMPENDIUM, *supra* note 16, at 1654.

19. *Comm. on Finance, supra* note 16, at 135.

subject. If an individual invests directly in an operating company, he must indirectly bear the burden of the corporate income tax imposed upon the operating company as well as the additional burden of the income tax imposed on that portion of corporate earnings distributed to him as dividends. This effect is loosely referred to as "double taxation." However, where the individual invests indirectly through an investment company, if the investment company's income were subject to the corporate income tax, the individual investor would be burdened with yet another layer of taxation, a sort of "triple taxation." Under such circumstances, the use of an investment company as an investment medium would substantially increase the income tax burden of individual investors. Investors would be forced to forgo whatever advantages an investment company offers in order to avoid the additional tax burden, and investment companies would not survive.<sup>20</sup>

In recognition of this fact and the salutary role of regulated investment companies in our economy,<sup>21</sup> for approximately forty years the Internal Revenue Code has contained special provisions governing the taxation of regulated investment companies and their shareholders.<sup>22</sup> These provisions, now found in Subchapter M,<sup>23</sup> are designed to subject an individual investing through the medium of an investment company to substantially the same tax burden he would bear if he had made an equivalent investment directly in the securities held by the investment company.<sup>24</sup> In essence, the investment company is treated as a conduit through which its income is passed to its shareholders.<sup>25</sup>

In accordance with this principle, when an investment company distributes dividends to its shareholders out of its capital gains, the capital gains character of these dividends may be "passed through" to the recipient shareholders for purposes of taxation of the shareholders.<sup>26</sup> Similarly, when a qualified investment company pays taxes to foreign governments on

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20. *Id.*

21. Regulated investment companies . . . perform two basic functions in our economy. They provide a medium of intelligent equity investment for persons of moderate means, who might otherwise be precluded from including equity investment in their financial plans. The second function they perform is a related one: they bring to our Nation's capital markets funds for equity investment which might otherwise not be available.

3 COMPENDIUM, *supra* note 16, at 1671.

22. *Id.* at 1660.

23. The provisions governing the taxation of regulated investment companies and their shareholders are found in I.R.C. §§ 851-55.

24. *Comm. on Finance, supra* note 16, at 135. A regulated investment company that satisfies the requirements of Subchapter M will be taxed at the usual corporate rates only on income not distributed currently to its shareholders. Dividends distributed to shareholders will be individually taxable to the recipient shareholders. See Clark, *The Federal Income Taxation of Financial Intermediaries*, 84 YALE L.J. 1603, 1624-27 (1975).

25. 3 COMPENDIUM, *supra* note 16, at 1660.

26. I.R.C. §§ 852(b)(3)(B) & (C).

income from securities held in foreign corporations, the company's resulting foreign tax credits may be passed through to the shareholders.<sup>27</sup>

In contrast to the pass-through treatment provided for capital gains and foreign tax credits, there was no pass-through provision for tax-exempt municipal bond interest prior to the Amendment. If a regulated investment company invested in tax-exempt municipal bonds, the tax-exempt character of the interest on the bonds was lost when the interest was distributed to the company's shareholders.<sup>28</sup> Although there was no specific provision in the Code concerning the distribution of tax-exempt interest by an investment company, it had been held that such distributions constituted taxable income to the shareholders.<sup>29</sup> The tax-exempt interest was regarded as losing its character as interest upon passing through the corporation and as being transmuted into dividend income in the hands of the shareholders.<sup>30</sup> As a result, the interest when received by the shareholders was no longer considered within the exemption for interest on municipal bonds provided in section 103 of the Code.

The absence of pass-through treatment for municipal bond interest in effect excluded investment companies from participating in the municipal bond market.<sup>31</sup> Significantly, this treatment of tax-exempt interest was an aberration from the principle underlying Subchapter M that an investor in a regulated investment company should bear substantially the same tax burden he would bear if he were to make an equivalent investment in the securities held by the investment company.<sup>32</sup> Legislation to rectify this

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27. I.R.C. § 853(b)(2). In effect, the shareholder of a qualified investment company is placed in the same position as a person owning stock directly in a foreign corporation. Treas. Reg. § 1.853-2(b) (1957). To qualify for the election to allow foreign tax credits to be passed through to its shareholders, a regulated investment company must conform to the requirements set forth in I.R.C. §§ 853(a) & (b).

28. See 3 COMPENDIUM, *supra* note 16, at 1660.

29. *Id.*

30. *Id.*

31. See *Alternatives to Tax-Exempt State and Local Bonds: Hearings Before the House Comm. on Ways and Means*, 94th Cong., 2d Sess. 194 (1976) (statement of Robert L. Augenblick). A survey in 1959 of the member companies of the National Association of Investment Companies revealed that approximately one tenth of one percent of the assets of these investment companies was invested in municipal bonds. 3 COMPENDIUM, *supra* note 16, at 1664.

32. The absence of a specific provision permitting the tax-exempt character of municipal bond interest to be passed through an investment company to its shareholders may not have been the result of a deliberate policy decision. See *Comm. on Finance*, *supra* note 16, at 135. The exclusion of regulated investment companies from the municipal bond market was not a matter of concern when the provisions of the Code governing regulated investment companies were enacted. *Id.* The interest rates on municipal bonds were much lower than the rates on taxable securities. *Id.* Consequently, the only individual investors to whom municipal bonds were financially attractive were individuals in relatively high income tax brackets. See 3 COMPENDIUM, *supra* note 16, at 1661. See generally note 44 *infra*. These investors can obtain the benefits of diversification of risk and expert investment management without resorting to the medium of an investment company. See 3 COMPENDIUM, *supra* note 16, at 1660. Moreover, the low interest rates indicated that the municipal

inconsistency in the general pass-through treatment accorded regulated investment companies was first proposed in the President's Economic Report to the Congress in January 1955.<sup>33</sup> The support needed to pass such legislation did not develop, however, until the capacity of the municipal bond market to continue providing state and local governments with needed capital became a matter of Congressional concern.<sup>34</sup> This concern arose as a result of two significant trends: (1) the increase in the capital needs of state and local governments, and (2) the decrease in the participation of commercial banks in the municipal bond market.

The increase in the capital demands of state and local governments has been dramatic. During the last two decades, local governments have taken on responsibilities in a wide range of new areas, such as public housing, urban renewal, and transportation.<sup>35</sup> A sharp rise in construction costs has made the burden of meeting these new responsibilities particularly difficult to bear.<sup>36</sup> With the resulting increase in their capital needs,<sup>37</sup> state and local governments have become increasingly reliant upon the municipal bond market as a source of needed capital.<sup>38</sup> Yet at the same time, the market's most important group of investors has reduced its level of participation. Commercial banks make up the most important single component of the market.<sup>39</sup> During the period between 1960 and 1970, commercial banks absorbed over seventy percent of the net new issues of municipal bonds, and their share of the total municipal bonds outstanding almost doubled.<sup>40</sup> During the 1970's, however, the percentage of net new issues of municipal

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bond market at that time provided state and local governments with a reliable and sufficient source of capital. There was, therefore, no need to resort to further tax incentives to bring additional investors into the municipal bond market.

33. *Id.* at 1664.

34. See generally 122 CONG. REC. S13715 (daily ed. Aug. 6, 1976) (remarks of Sen. Percy).

35. *General Tax Reform: Panel Discussions Before the House Comm. on Ways and Means*, 93rd Cong., 1st Sess. 1175 (1973) [hereinafter cited as *Panel Discussions*] (statement of John Driggs).

36. Between 1953 and 1969, state and local construction costs rose 105 percent, more than twice the rate of other prices in the economy. *Id.*

37. The rate of increase in state and local government expenditures exceeded the rate of increase of both the federal budget and inflation during the period from 1950 to 1975. Casey & Smith, *A New Look at Municipal Bonds — Disclosure Responsibilities in the Municipal Bond Market*, 50 ST. JOHN'S L. REV. 639, 639 & nn.2 & 3 (1976).

38. The total of outstanding state and local government debt increased from \$18.8 billion in 1950 to \$154 billion in June, 1971. *Panel Discussions*, *supra* note 35, at 1172 (statement of John Driggs).

39. Cabinet, *The Municipal Bond Interest Exemption: Comments on a Running Battle*, 24 CASE W. RES. L. REV. 64, 76 (1972).

40. *Comm. on Finance*, *supra* note 16, at 35. However, despite the fact that municipal bonds have been a peculiarly desirable investment for commercial banks, banks view as their primary function the supply of loans to businesses and individuals on a short-term basis, in keeping with the predominantly short-term nature of their liabilities. Galper & Petersen, *An Analysis of Subsidy Plans to Support State and Local Borrowing*, 24 NAT'L TAX J. 205, 209 (1971) [hereinafter cited as Galper & Petersen]. Consequently, the demand for municipal bonds by commercial



bonds absorbed by commercial banks has declined significantly.<sup>41</sup> Many municipal bond experts have expressed concern that commercial banks may not support the municipal bond market in the future to anywhere near the extent that they did in the 1960's.<sup>42</sup>

As a result of the partial withdrawal of commercial banks from the municipal bond market, state and local governments have been forced to seek capital from other sources. While the tax-exempt status of municipal bonds lowers the cost of capital to borrowing governments,<sup>43</sup> it also limits participation in the market to those investors who find the exemption valuable.<sup>44</sup> There are three major groups of investors in the municipal bond market: commercial banks; fire and casualty insurance companies; and households, a group comprised of individuals, personal trusts, and nonprofit organizations.<sup>45</sup> Historically, when commercial banks have withdrawn funds from the municipal bond market, the only major alternative source for the replacement of these funds has been the household sector, particularly individual investors.<sup>46</sup> In order to sell more municipal bonds to individuals,

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banks is largely determined by the availability of funds after liquidity needs and loan requirements are satisfied. *See id.*

41. *See Comm. on Finance, supra* note 16, at 35.

42. *See, e.g., Morris, The Taxable Bond Option*, 29 NAT'L TAX J. 356, 356 (1976). The withdrawal of commercial banks from the municipal bond market is due in part to the development of new tax shelters provided by foreign investments that generate foreign tax credits, and the expansion of banks into new activities, such as real property and equipment leasing, that generate accelerated depreciation and investment tax credits. *Comm. on Finance, supra* note 16, at 168 (written communication to the Committee from Peter Fortune).

43. The tax-exempt status of municipal bonds permits them to be sold at a discount because investors are willing to accept a lower interest rate or yield if the interest is not includable in taxable income. Ritter, *Federal Income Tax Treatment of Municipal Obligations: Industrial Development Bonds*, 25 TAX LAW 511, 511 (1972). During the period 1960 to 1975, interest rates on municipal bonds ranged from 66% to 75% of the rates on comparable taxable securities. *Comm. on Finance, supra* note 16, at 40 (Table 4) (statement of Robert A. Gerard). This yield differential is a function of the progressivity of the federal income tax and the volume of municipal bonds issued. Martori & Bliss, *Taxation of Municipal Bond Interest — "Interesting Speculation" and One Step Forward*, 44 NOTRE DAME LAW. 191, 191 (1968) [hereinafter cited as Martori & Bliss].

44. *See Galper & Petersen, supra* note 40, at 208. The value of a tax exemption to an individual is dependent upon his taxable income. An investor in a higher tax bracket will enjoy greater advantages from the purchase of tax-exempt bonds than an investor in a lower tax bracket. For example, in 1968 a municipal bond with a 4.55% interest rate was the equivalent of a taxable bond with a 5.77% interest rate for a couple with a taxable income of \$10,000 who filed a joint return. Martori & Bliss, *supra* note 43, at 212. For a couple with a joint taxable income of \$100,000, the same municipal bond was the equivalent of a taxable bond with an 11.5% rate. *Id.* Consequently, when interest rates on tax-exempt municipal bonds are low, only individuals in relatively high income tax brackets would gain more from investing in municipal bonds rather than taxable securities offering higher interest rates.

45. *See Galper & Petersen, supra* note 40, at 208. Other groups have participated in the municipal bond market from time to time, but their participation has been of only minor significance. *Id.*

46. *Id.*

the interest rates on these bonds must increase to encourage existing buyers to purchase more bonds and to induce new buyers to enter the market.<sup>47</sup> To accomplish this, municipal bonds must be sold at interest rates more closely comparable to the rates on taxable securities, thus making municipal bonds more attractive to individuals in lower income brackets who get less advantage from the exemption.<sup>48</sup> As state and local governments have increased the quantity of their borrowings, interest rates on municipal bonds have increased considerably.<sup>49</sup> This marked increase in tax-exempt interest rates has made municipal bonds more attractive to individuals in lower income tax brackets.<sup>50</sup> However, the void created by decreased participation of commercial banks in the market typically has not been fully offset by a corresponding increase in the participation of individual investors.<sup>51</sup>

According to the advocates of pass-through treatment of municipal bond interest, the reason for investor reluctance was that a number of obstacles effectively prevented many individuals from taking advantage of the increase in interest rates on municipal bonds.<sup>52</sup> Municipal bonds were generally issued in denominations of \$1,000, often with a minimum purchase requirement of \$5,000 — a price too high for many small investors.<sup>53</sup> Furthermore, the municipal bond market is complex. Thousands of state and local governmental entities issue municipal bonds and many have outstanding bonds that have been issued at different times and at different interest rates. In this situation, the average individual investor lacks the necessary expertise to appraise the quality, safety, and market price of outstanding municipal bonds.<sup>54</sup> In addition, market quotations for municipal bonds are not as readily available as they are for other securities, and the large number of municipal bond issues outstanding makes the acquisition of such information a burdensome task.<sup>55</sup> Finally, in order to

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47. Surrey, *Federal Income Taxation of State and Local Government Obligations*, 36 TAX POL'Y 1, 5 (May-June 1969).

48. *Id.*

49. *Comm. on Finance*, *supra* note 16, at 135. Between 1963 and March 1976, the average yield on seasoned Aaa municipal bonds increased from 3.06% to 5.99%. *Id.* at 135 n.2.

50. *See id.* at 135. Interestingly, as early as 1959 advocates of pass-through treatment for the tax-exempt character of municipal bond interest asserted that tax-exempt yields had increased sufficiently to make municipal bonds attractive to individuals in lower tax brackets. *See* 3 COMPENDIUM, *supra* note 16, at 1662.

51. *Comm. on Finance*, *supra* note 16, at 35. Despite relatively high interest rates, not all individuals in the middle and upper income tax brackets are interested in holding municipal bonds or, for that matter, any fixed income security. Galper & Petersen, *supra* note 40, at 211. Municipal bonds appear to be a preferred form of investment for those who are interested in a safe, steady return on their investment and who favor current income over capital gains. *Id.* at 211 n.12.

52. *See Comm. on Finance*, *supra* note 16, at 135-36.

53. *Id.* at 135.

54. *Id.* at 135-36.

55. *Id.* at 136.

liquidate a small investment in municipal bonds (a principal amount of less than \$10,000 or \$20,000) an investor must usually suffer a sacrifice in price.<sup>56</sup>

The Amendment's proponents maintained that regulated investment companies offered a medium through which a person of moderate income could overcome the obstacles confronting investors in the municipal bond market.<sup>57</sup> They pointed out that investment company shares are generally priced in the range of \$10 to \$25 per share,<sup>58</sup> a price substantially lower than that of municipal bonds.<sup>59</sup> Moreover, the portfolio of a regulated investment company is managed by expert investment advisors;<sup>60</sup> thus, individual investors need not be concerned about the complexities of the market. In addition, the market value of regulated investment company shares, unlike those of municipal bonds, are readily ascertainable. The net asset value of investment company shares is determined daily and reported in newspapers throughout the country.<sup>61</sup> Finally, in contrast to a small investment in municipal bonds, investment company shares may be liquidated without sacrifice in price, as investment companies will redeem shares for their net asset value at the shareholder's election.<sup>62</sup>

These assertions were raised before Congress at a most opportune time. There has been increasing concern that the existing municipal bond market cannot continue to satisfy the growing needs of state and local governments for capital financing at reasonable interest rates.<sup>63</sup> Although there is no certainty that increases in credit demands of state and local governments will overwhelm the resources of the municipal bond market,<sup>64</sup> the difficulties that many states, cities and counties have experienced in attempting to raise revenue for capital improvements and other projects have not gone

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56. *Id.*

57. *Id.* at 135; 3 COMPENDIUM, *supra* note 16, at 1662. Some of the obstacles cited may be more apparent than real. Individual investors need not confront the complexities of the municipal bond market alone. They may call upon the expertise of a stockbroker just as is commonly done in the taxable securities market. Similarly, although market quotations for municipal bonds may not be as readily available as those for taxable securities, information may be obtained from a stockbroker. Nevertheless, the large minimum purchase requirements and the penalties incurred when a small investment is liquidated, along with stockbrokers' disinclination to promote small investments in municipal bonds are obstacles of sufficient substance to preclude an individual of limited wealth and expertise from participating directly in the municipal bond market.

58. *Alternatives to Tax-Exempt State and Local Bonds: Hearings Before the House Comm. on Ways and Means*, 94th Cong., 2d Sess. 195 (1976) (statement of Robert L. Augenblick).

59. *See Comm. on Finance*, *supra* note 16, at 135.

60. *Id.*

61. *Id.* at 136.

62. *Id.*

63. *See, e.g., Panel Discussions*, *supra* note 35, at 1175 (statement of John Driggs); Surrey, *Federal income Taxation of State and Local Government Obligations*, 36 TAX POL'Y 1, 3 (May-June 1969).

64. *See, e.g., Healy, Further Comments on Proposed Capital Financing Alternatives*, 37 TAX POL'Y 1, 2 (Jan.-Feb. 1970). *See generally* TAX FOUNDATION, INC., THE FINANCIAL OUTLOOK FOR STATE AND LOCAL GOVERNMENT TO 1980, at 11 (1973)

unnoticed by the financial community and Congress.<sup>65</sup> These difficulties provided an impetus for Congress to pass legislation designed to bring the virtually untapped capital resources of regulated investment companies into the troubled municipal bond market.<sup>66</sup> This objective was accomplished by enactment of the Amendment, allowing investment companies to pass through to their shareholders the tax-exempt character of interest on municipal bonds.

#### A PRINCIPLED STATE RESPONSE TO THE AMENDMENT

Prior to the amendment to section 852(b) of the Internal Revenue Code, any dividends paid by a regulated investment company out of its tax-exempt interest would have been included in the recipient shareholder's federal adjusted gross income.<sup>67</sup> Because Maryland uses the federal adjusted gross income figure as the state income tax base,<sup>68</sup> prior to the Amendment exempt-interest dividends were included in Maryland taxable net income and were subject to Maryland income taxation. Since the enactment of the Amendment, exempt-interest dividends are no longer included in federal adjusted gross income.<sup>69</sup> Consequently, absent a modification provision to the contrary, exempt-interest dividends would be automatically excluded from the computation of Maryland taxable net income and would be exempt from Maryland income taxation.

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(furnishes grounds for cautious optimism concerning the fiscal outlook of state and local governments).

One commentator, challenging the validity of the alarms sounded by others that an increase in the supply of credit to state and local governments is needed, has maintained:

The important point, as economist Sidney Homer has stated, is: . . . "Capital requirements are infinite," or that "state and municipal requirements are infinite." The determining factor of the volume of new facilities that will be created is not need; the limiting factor always is somebody's ability and willingness to finance new facilities and somebody else's ability and willingness to service the debt."

Healy, *The Assault on Tax-Exempt Bonds*, 36 TAX POL'Y 2, 5 (July-Aug. 1969). Rather than being directed to the issue of whether state and local governments need new sources of capital, this response seems to redefine the problem of satisfying the capital needs of state and local governments as a market condition rather than a problem. In any event, the uncertainty in much of the supporting data of both viewpoints makes it difficult to choose between pessimism and optimism with respect to prognostications of the future of the municipal bond market. Gabinet, *The Municipal Bond Interest Exemption: Comments on A Running Battle*, 24 CASE W. RES. L. REV. 64, 77 (1972).

65. See 122 CONG. REC. S13715 (daily ed. Aug. 6, 1976) (remarks of Sen. Percy); *Panel Discussions*, *supra* note 35, at 1175 (statement of John Driggs).

66. See generally 122 CONG. REC. S13715 (daily ed. Aug. 6, 1976) (remarks of Sen. Percy); *Comm. on Finance*, *supra* note 16, at 134-36; *Alternatives to Tax-Exempt State and Local Bonds: Hearings Before the House Comm. on Ways and Means*, 94th Cong., 2d Sess. 193-200 (1976) (statement of Robert L. Augenblick).

67. See text accompanying notes 28 to 30 *supra*.

68. See text accompanying note 13 *supra*.

69. See note 6 *supra*.

Current Maryland tax laws already provide for modification to federal adjusted gross income for interest on municipal bonds held directly by individuals. Section 280(b)(1) of Article 81 of the Annotated Code of Maryland provides that in computing Maryland adjusted gross income, there shall be added to federal adjusted gross income "interest or dividends, (less related expenses), on obligations or securities of any state or of a political subdivision or authority thereof (other than this state and its political subdivisions and authorities) . . . ." Under this provision, interest on municipal bonds of states other than Maryland is subject to Maryland income taxation, whereas interest on Maryland municipal bonds is exempt from taxation. Section 280(b)(1) was adopted prior to the existence of the concept of exempt-interest dividends under the Code.<sup>70</sup> When the Amendment became effective, it was not clear whether exempt-interest dividends were within the scope of section 280(b)(1) — in other words, it was not clear whether dividends paid by a regulated investment company out of municipal bond interest were equivalent to "interest or dividends . . . on obligations or securities of any state or of a political subdivision or authority thereof" that must be added to federal adjusted gross income in computing Maryland taxable income.

In order to clarify the application of section 280(b)(1) to dividends paid by an investment company from municipal bond interest, the Maryland Income Tax Division of the Comptroller of the Treasury issued an interpretive opinion, designated as Memorandum Release No. 17,<sup>71</sup> concerning the taxation of exempt-interest dividends. This Memorandum provides in part:

When applying Section 280(b)(1), interest — dividends on obligations of states other than Maryland and their subdivisions, flowing through from the mutual fund must be added to Federal adjusted gross income. Any flow-through of interest-dividends on obligations and securities of the State of Maryland and its political subdivisions will escape the modification addition and will be nontaxable.<sup>72</sup>

Under this interpretation, exempt-interest dividends attributable to bonds of Maryland and its political subdivisions and authorities are exempt from Maryland income taxation, while exempt-interest dividends attributable to municipal bonds of states other than Maryland are subject to Maryland income taxation.

If the language of section 280(b)(1) were construed in isolation, exempt-interest dividends would seem to lie outside the scope of section 280(b)(1) for the reason that dividends paid by an investment company are not technically "interest or dividends . . . on obligations or securities of any

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70. See MD. ANN. CODE art. 81, § 280(b)(1) (1975) (current version in Cum. Supp. 1977).

71. Income Tax Division Memorandum Release No. 17, 1 MD. TAX REP (CCH) ¶ 11-305.25 (Feb. 10, 1977).

72. *Id.*

state." As noted in Memorandum Release No. 17, however, because Maryland has adopted a policy of conformance between the state income tax law and the federal income tax law,<sup>73</sup> the character of income as defined in the Internal Revenue Code must be recognized for purposes of state taxation, absent a specific provision to the contrary. Under section 852(b)(5)(B) of the Internal Revenue Code as amended, "[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)(1)." Section 103(a)(1) of the Code provides an exemption for municipal bond interest.<sup>74</sup> Thus, absent a specific provision to the contrary, an exempt-interest dividend must be treated as municipal bond interest for purposes of Maryland taxation of the recipient shareholder. Therefore, exempt-interest dividends are properly within the scope of section 280(b)(1), the provision governing Maryland taxation of municipal bond interest. Under section 280(b)(1), exempt-interest dividends are exempt from Maryland income taxation only to the extent that such dividends are attributable to bonds issued by the State of Maryland and its political subdivisions and authorities. This is precisely the interpretation set forth in Memorandum Release No. 17.<sup>75</sup>

Beyond the need to clarify existing Maryland income tax laws in light of the Amendment, a further step remains to be taken. The Amendment, like every amendment to the Internal Revenue Code, should be evaluated by the legislature to determine whether conformity to the Amendment is consonant with state tax policy. When Maryland adopted federal adjusted gross income as the basis for its income tax, the Maryland legislature "deliberately and intentionally pronounced a doctrine of conformance between the State income tax law and the federal income tax law."<sup>76</sup> This doctrine naturally

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73. *Katzenberg v. Comptroller*, 263 Md. 189, 198, 282 A.2d 465, 470 (1971). See text accompanying note 76 *infra*.

74. See note 5 *supra*.

75. Inquiries were addressed to states that adopt the Code as currently in effect as the basis for the computation of state income tax in order to ascertain the manner in which exempt-interest dividends are treated for state income tax purposes. The response of every such state indicated that, as in Maryland, exempt-interest dividends are treated the same as municipal bond interest for purposes of taxation of the recipient shareholder. In other words, exempt-interest dividends are treated the same as if the municipal bond interest from which the dividends were paid had been paid directly to the individual recipients. See, e.g., Letter from G.E. May, Supervisor of Income & Withholding Tax of Colorado, to *Maryland Law Review* (June 3, 1977); Letter from Gabriel B. DiCerbo, Chief of Regulations and Interpretations Section of the Income Tax Bureau of New York, to *Maryland Law Review* (June 24, 1977); Hawaii, however, must specifically adopt amendments to the Code before such amendments are incorporated in Hawaii income tax laws. HAW. REV. STAT. § 235-2 (1976). The 1977 Hawaii state legislature failed to adopt the Amendment, probably due to an oversight; consequently, the pass-through treatment of municipal bond interest provided by the Amendment was not in effect in Hawaii as of May 27, 1977, the time of inquiry. See Letter from George Freitas, District Tax Administrator of Hawaii, to *Maryland Law Review* (May 27, 1977).

76. *Katzenberg v. Comptroller*, 263 Md. 189, 198, 282 A.2d 465, 470 (1971), (quoting 52 OP. ATT'Y GEN. 451, 452 (1967)).

gives rise to a presumption that Maryland tax laws will continue to conform to the Code as amended from time to time. Nevertheless, by adopting federal adjusted gross income as a basis for the state income tax rather than simply assessing a fixed percentage of each taxpayer's federal tax liability, and by providing for modifications to the federal adjusted gross income figure, the legislature indicated that absolute conformance to the Internal Revenue Code was not intended. In contrast to a state that simply assesses a fixed percentage of each taxpayer's federal tax liability,<sup>77</sup> Maryland has not completely tied its income tax to federal exemptions, deductions, and exclusions. In this way, the Maryland legislature has retained the prerogative to evaluate an amendment to the Code and to decide whether, in a particular instance, conformance with the federal tax law as amended is consonant with state tax policy.

In exercising this prerogative, initial consideration should be given to the reasons for which the amendment was enacted by Congress. Such consideration would ensure full understanding of the amendment's impact on the state income tax, and would reveal whether the reasons for the amendment's enactment have any validity on the state level. Reference should then be made to the same principles of tax policy that have long been applied to federal income tax laws.<sup>78</sup> In particular consideration should be given to the following criteria: (1) non-tax state policy,<sup>79</sup> (2) equity, (3) simplicity, and (4) the impact on tax revenue. In most instances, evaluation of a Code amendment according to these criteria would be a simple task and would provide a principled answer to the question whether sufficient reason exists for an exception to the general rule of conformity to the Code. The remainder of this Comment will illustrate how a state legislature should resolve this question in a particular case by analyzing whether the pass-through treatment of municipal bond interest provided by the Amendment is consonant with Maryland tax policy.

Preliminarily, it should be noted that in many cases the criteria set forth above may conflict with one another. Where they conflict, the competing interests involved must be weighed against each other to determine whether

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77. See VT. STAT. ANN. tit. 32, § 5822 (1970) (state income tax liability computed by applying a 25% flat rate to the taxpayer's federal tax liability).

78. See generally R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 192-93 (1973) [hereinafter cited as MUSGRAVE]; HOUSE COMM. ON WAYS AND MEANS, 86TH CONG. 1ST SESS., 1 TAX REVISION COMPENDIUM 87 (Comm. Print 1959) (statement of Roswell Magill). "[T]he criteria of a good tax system have changed little since Adam Smith's day — equity, adequacy, neutrality, simplicity, and ease of compliance and administration. Any revision should make the tax system conform more closely to these principles." *Id.*

79. Although the use of the income tax as a vehicle for effecting economic and social goals has been challenged generally as an inefficient means of attaining such goals, see S. SURREY, PATHWAYS TO TAX REFORM 209-22, 247 (1973), tax reformers continue to recognize that the income tax may sometimes provide a suitable instrument for effecting economic policy. See, e.g., MUSGRAVE, *supra* note 78, at 193; S. SURREY, TAX POLICY AND TAX REFORM: 1961-1969, at 29-32 (W. Hellmuth & O. Oldman eds. 1973).

other considerations override the reasons for conformance to the Internal Revenue Code. For example, the Maryland Senate Finance Committee proposed a bill in 1972 for the purpose of taxing income that receives preferential federal income tax treatment.<sup>80</sup> In its report to the Maryland General Assembly, the committee stated that "tax equity demands that the State capture some taxes from this kind of preferred income."<sup>81</sup> Furthermore, it was estimated that the bill would produce substantial additional tax revenues.<sup>82</sup> Simplicity, however, called for not taxing items of federal tax preference because doing so would increase the complexity of the state income tax. In this particular instance, considerations of equity and the impact on tax revenue presented overriding justifications for a deviation from the general rule of conformity, and the proposed modification was properly enacted.<sup>83</sup>

As a basic starting point for deciding whether conformance to the Amendment is desirable, the legislature should consider whether the reasons for the enactment of the Amendment have any validity on the state level. This question requires analysis wholly independent from that developed with respect to the federal income tax, for the concerns of federal and state governments often differ.<sup>84</sup> The Amendment provided an exemption for dividends paid by a regulated investment company from municipal bond interest for two reasons: (1) to expand the municipal bond market and (2) to remove an inconsistency in the provisions of the Code governing regulated investment companies.<sup>85</sup> Unlike the federal government, however, Maryland is not concerned with the ability of other states and their political subdivisions to satisfy their debt demands through the sale of municipal bonds. Maryland is concerned solely with the ability of the State of Maryland and its political subdivisions and authorities to obtain capital in the municipal bond market. Consequently, with regard to this limited concern, an exemption from Maryland income taxation is justified only to the extent that such an exemption facilitates the marketing of Maryland bonds.

For this reason Maryland income tax laws provide an exemption for interest on only Maryland municipal bonds.<sup>86</sup> This policy serves to facilitate

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80. See LEGISLATIVE COUNCIL OF MARYLAND, REPORT TO THE GENERAL ASSEMBLY OF 1973 — PROPOSED BILLS 321 (1972).

81. *Id.*

82. *Id.*

83. See MD. ANN. CODE art. 81, § 280(b)(4) (Cum. Supp. 1977).

84. One of the basic differences between the federal and Maryland tax laws is a philosophical one. The federal income tax is frequently used as a means of effecting social or economic policies, whereas the Maryland income tax is rarely used for any purpose other than to raise revenues. Interview with Benjamin L. Cardin, Chairman of Maryland House Committee on Ways and Means, in Baltimore (Jan. 13, 1978). The tax preference provided by Maryland law for interest on Maryland municipal bonds is one instance of the use of the Maryland income tax as a means of effecting a state economic policy. See text accompanying notes 85 to 86 *infra*.

85. See text accompanying notes 31 to 34 & 64 to 66 *supra*.

86. Not all states provide a tax preference to holders of their municipal bonds. There are basically three possible ways of taxing municipal bond interest: (1) exempt



the marketing of Maryland bonds by encouraging Maryland taxpayers to purchase Maryland bonds rather than those of other states. However, the reason for the tax preference for interest on Maryland municipal bonds has little force where the municipal bond interest is paid to a mutual fund which distributes the interest as dividends to its shareholders. A municipal bond mutual fund generally holds a diversified portfolio composed of bonds issued by various states, and the shareholders of the fund are typically residents of many different states. Consequently, even though the portion of an exempt-interest dividend attributable to interest on Maryland obligations is excluded from taxable income, this benefit can be enjoyed only by the small percentage of mutual fund shareholders who are Maryland taxpayers, and only to the extent that the fund's portfolio includes Maryland bonds. It is unlikely, therefore, that the tax policy of Maryland or of any one state will have a substantial influence on the investment decisions of municipal bond mutual funds. Thus, the justification for an exemption for municipal bond interest attributable to Maryland bonds when paid directly to individuals does not extend to the situation where such municipal bond interest is paid indirectly in the form of exempt-interest dividends to shareholders of municipal bond mutual funds.<sup>87</sup> Accordingly, solely with regard to the policy

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interest on all municipal bonds regardless of the state of the issuer; (2) exempt interest only on those municipal bonds issued by the taxing state; or (3) tax interest on all municipal bonds, including those issued by the taxing state. Those states that exempt all municipal bond interest may do so because of strict adherence to the Code. *See, e.g.,* Letter from Christine Quinn, Administrative Assistant of the Audit Division, Department of Revenue of Alaska, to *Maryland Law Review* (June 8, 1977). Those states that exempt interest on only municipal bonds of the taxing state may do so for the same reason Maryland does — to facilitate the marketing of their own bonds by encouraging taxpayers to purchase bonds of their own state rather than those of other states, *see, e.g.,* Letter from Howard O. Vralsted, Administrator of the Income Tax Division of Montana, to *Maryland Law Review* (June 1, 1977), or simply to conform to the tax policies of other states, *see* Letter from George Freitas, District Tax Administrator of Hawaii, to *Maryland Law Review* (May 27, 1977). Those states that tax interest on all municipal bonds may do so because such a policy is deemed equitable, or, in other words, "to apply the lowest possible rates to the broadest possible base." Letter from Robert M. Whitler, Director of Revenue of Illinois, to *Maryland Law Review* (June 10, 1977). A further reason for the variance in state tax treatments of municipal bond interest may be due to a variance among the states in the extent of reliance on bonds as a means for capital financing.

87. Advocates of the mutual fund industry have contended that because municipal bond mutual funds offer state and local governments a new source of capital, the growth of these funds should be encouraged to the utmost by providing the most favorable tax climate possible. Interview with H. Spencer Everett, Jr., Vice President, General Counsel & Secretary of T. Rowe Price Associates, Inc., in Baltimore (Jan. 1977). If Maryland were to exempt all exempt-interest dividends, perhaps Maryland taxpayers would increase their investments in municipal bond mutual funds. If an increase were to result, there would be a corresponding increase in the growth of municipal bond mutual funds, which might lead to an increase in the demand for Maryland bonds. Even though this contention does have some merit, the links of its theoretical chain are somewhat attenuated and do not present a compelling justification for exempting all exempt-interest dividends regardless of their source. *See generally* text accompanying notes 89 to 96 *infra*.

of promoting the marketing of Maryland bonds, no exemption for exempt-interest dividends is justified; hence, such dividends should be subject to Maryland income taxation.

The second reason for the enactment of the Amendment was to remove an inconsistency in the tax treatment of regulated investment companies under Subchapter M.<sup>88</sup> By adopting federal adjusted gross income as the starting point for the computation of Maryland taxable income, Maryland in effect has adopted the entire federal income tax scheme, including Subchapter M. Consequently, the inconsistency that existed in the federal taxation of regulated investment companies prior to the Amendment was mirrored by an inconsistency in the Maryland taxation of investment companies. With the removal of this inconsistency from the federal scheme, there is no longer any inconsistency in the Maryland tax treatment of regulated investment companies. Under the current exemption for exempt-interest dividends attributable to Maryland municipal bonds, the shareholder of a municipal bond mutual fund is treated as if he owned directly his pro rata share of the bonds held by the fund. This exemption, therefore, is justified, at least in part, because it is consistent with the general treatment of regulated investment companies under both the federal and Maryland tax laws.

After considering the justifications for the enactment of the Amendment by Congress and the pertinent non-tax state policies, consideration should be given to the criteria of equity, simplicity, and the impact on tax revenue. While not always controlling, equity is the most basic criterion in the formulation of any tax policy.<sup>89</sup> The prime objective of income tax reform on the federal level is to achieve greater fairness in the federal tax system.<sup>90</sup> Equity has two dimensions: (1) that individuals with equal incomes should bear equal tax burdens, and (2) that there should be some measure of progressivity so that those with higher incomes should bear greater proportionate tax burdens in accordance with their ability to pay.<sup>91</sup> Operationally, the underlying concept of equity is one of making the effective tax rates conform as closely as possible to the statutory rates.<sup>92</sup>

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88. See text accompanying notes 28 to 33 *supra*.

89. MUSGRAVE, *supra* note 78, at 193.

90. S. SURREY, *PATHWAYS TO TAX REFORM* 31 (1973).

91. S. SURREY, *TAX POLICY AND TAX REFORM: 1961-1969*, at 647 (W. Hellmuth & O. Oldman eds. 1973). These two dimensions of equity are often referred to as horizontal and vertical equity. While there is general agreement as to horizontal equity, opinion as to what constitutes vertical equity differs more widely. While most commentators favor some degree of progression, some argue for taxation proportional to income. See G. FISCHER, *TAXES AND POLITICS: A STUDY OF ILLINOIS PUBLIC FINANCE* 229 (1969). Although the debate over the justification for progressive taxation still continues among academicians, the general public as well as politicians have long accepted the principle that progressive taxes are more equitable than either proportional or regressive taxes. Keller, *The Case for Highly Graduated Rates in State Income Taxes*, 35 MD. L. REV. 617, 628 n.33 (1976). See generally Blum & Kalven, *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

92. *Panel Discussions*, *supra* note 35, at 1181 (statement of Harvey Galper).

In one sense, the exemption for exempt-interest dividends attributable to Maryland municipal bonds may be considered inequitable for the same reason that any income tax exemption is inequitable — it erodes the progressivity of the Maryland income tax by eliminating a normally taxable item of income from the tax base.<sup>93</sup> It may seem, therefore, that the interests of equity would best be served by eliminating the exemption for exempt-interest dividends attributable to Maryland bonds. The equity of a single tax law, however, must be viewed within the context of the entire tax system. Although the ultimate goal of equity may require the elimination of all exemptions that permit income to escape taxation, principles of equity are not necessarily furthered by the elimination of a particular exemption. Given the current exemption for interest on Maryland municipal bonds,<sup>94</sup> consistency with the principle underlying the taxation of regulated investment companies — that a shareholder of an investment company should be treated as if he owned directly his pro rata share of the securities held by the company — calls for an exemption for interest dividends attributable to Maryland bonds. Accordingly, within the current framework of the Maryland income tax system, it would be inconsistent and, therefore, inequitable to tax all exempt-interest dividends without regard to their source.<sup>95</sup> Similarly, it would be inconsistent to exempt all exempt-interest dividends in conformance with the Amendment. Such an inconsistency

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93. The federal exemption for municipal bond interest has been criticized as a glaring source of inequity in the federal income tax structure. See, e.g., S. SURREY, *PATHWAYS TO TAX REFORM* 210-11 (1973). In addition to the erosive effect the exemption has on effective tax rates, the exemption operates, as do all exemptions, so that those with higher incomes obtain greater benefits than those with lower incomes. See *id.* at 136. In response to these criticisms, one commentator has asserted that "[t]he contribution to equity if tax-exempt income had been taxed would have been far less than the contribution investors have made to states and localities in giving up higher interest opportunities and would have been miniscule compared with the damage done to state and local borrowing ability." Healy, *Comments on Proposed Capital Financing Alternatives*, 37 *TAX POL'Y* 1, 12 (Jan.-Feb. 1970).

In one sense, municipal bondholders pay a substantial hidden "tax" to the issuing state and local governments by accepting lower rates of return than those available for taxable securities. S. SURREY, *PATHWAYS TO TAX REFORM* 211 (1973). To the extent that the yield differential is exceeded by the amount of tax avoided by investing in tax-exempt bonds, however, the municipal bond investor has effectively avoided taxes.

94. Whether the current exemption for interest on Maryland municipal bonds should be continued is an issue beyond the scope of this Comment.

95. Taxing all exempt-interest dividends, however, would not be inconsistent with the policy embodied in § 280(b)(1). The tax preference for Maryland municipal bonds should be granted only when doing so would serve to facilitate the marketing of Maryland bonds. Because the exemption for exempt-interest dividends attributable to Maryland bonds does not serve to substantially further this goal, see text accompanying notes 85 to 87 *supra*, all exempt-interest dividends may be taxed without conflicting with the policy underlying the tax preference for Maryland bonds. Nevertheless, taxing all exempt-interest dividends without regard to their source would conflict with the principle underlying the taxation of regulated investment companies which requires that a shareholder of a mutual fund be treated as if he owned directly his proportionate share of the municipal bonds held by the fund.

would constitute an inequity greater than any inequity that currently exists as a result of the exemption for interest-dividends attributable to Maryland bonds.<sup>96</sup>

One criterion of tax policy that increasingly has become the focus of attention on both federal and state levels is the simplification of a tax system which is often unjustifiably complex.<sup>97</sup> Refinements that make tax laws complex and tax forms unintelligible to taxpayers may discourage taxpayer compliance and lead to errors in preparation of returns, with resulting inefficiencies in the administration of the tax laws and higher collection costs.<sup>98</sup> In the context of a state income tax system based upon the federal adjusted gross income figure, the criterion of simplicity takes on special significance. The apparent basis for adopting a policy of conformance to the Internal Revenue Code as amended is the resulting ease of both taxpayer compliance and administration of the tax laws.<sup>99</sup> In addition, conformance to the Code as amended relieves the legislature of the difficult, if not futile, task of keeping pace with changes in federal law by piecemeal enactment of conforming amendments.<sup>100</sup> In most instances, any benefits

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96. In effect, taxing all exempt-interest dividends would place a greater tax burden on taxpayers in lower income tax brackets, who might only be able to participate in the municipal bond market indirectly through an investment company, than is placed on taxpayers in higher income tax brackets, who are able to hold municipal bonds directly and thereby enjoy the exemption provided by § 280(b)(1). See generally text accompanying notes 52 to 62.

97. See, e.g., S. SURREY, *TAX POLICY AND TAX REFORM: 1961-1969*, at 647 (W. Hellmuth & O. Oldman eds. 1973); MARYLAND LEGISLATIVE COUNCIL, COMMITTEE ON LEGISLATIVE AND FISCAL MATTERS: 1969 REPORT 80 (1969).

98. S. SURREY, *TAX POLICY AND TAX REFORM: 1961-1969*, at 647 (W. Hellmuth & O. Oldman eds. 1973).

99. See generally Walthall, *Alabama Income Tax Law — A Need for Revision*, 28 ALA. L. REV. 274 (1977). See also LEGISLATIVE COUNCIL OF MARYLAND, TECHNICAL SUPPLEMENT TO THE 1975 REPORT OF THE STATE TAX REFORM STUDY COMM. 127-28 (1976). The New York legislature, expressing the reasons underlying its decision to adopt a policy of conformance to the code, stated:

The legislature hereby finds and declares that the adoption by this state for its personal income tax purposes of the provisions of the laws of the United States relating to the determination of income for federal income tax purposes will (1) simplify preparation of state income tax returns by taxpayers, (2) improve enforcement of the state income tax through better use of information obtained from federal tax audits, and (3) aid interpretation of the state tax law through increased use of federal judicial and administrative determinations and precedents.

1960 N.Y. Laws, ch. 563, § 1, at 1746. The paucity of legislative history concerning Maryland's decision to adopt federal adjusted gross income as the state income tax base, however, precludes a precise determination of the extent to which this decision was based on the benefits of simplicity.

100. See generally Walthall, *ALABAMA INCOME TAX LAW — A Need for Revision*, 28 ALA. L. REV. 274, 319-20 (1977); Comment, *State Adoption of Federal Taxing Concepts — An Approach Offering Simplification of State Income, Death, and Gift Taxes*, 51 N.C.L. REV. 834, 838-42 (1973). A 1971 study of the discrepancies between the federal tax laws and those of the state of Utah concluded that the futility of attempting to keep pace with the changing federal law by piecemeal conforming

that might be gained by deviating from the general rule of conformity will be outweighed by the increased complexity that would result from such a deviation.

The Amendment, however, presents an unusual situation because it concerns a subject of taxation for which Maryland tax laws already provide an exception to the general rule of conformity to the Code. In computing Maryland taxable income, interest on municipal bonds of states other than Maryland presently must be added to the federal adjusted gross income figure.<sup>101</sup> Consequently, deviation from the general rule of conformance in this particular instance does not necessarily involve any substantial increase in complexity. While a policy of exempting all exempt-interest dividends in conformance with the Amendment would be simpler than the current policy of exempting only exempt-interest dividends attributable to Maryland bonds, a policy of taxing all exempt-interest dividends would be virtually as simple. Unlike either of these policies, the current policy set forth in Memorandum Release No. 17 requires municipal bond mutual funds to identify for their shareholders that portion of any exempt-interest dividends attributable to Maryland bonds.<sup>102</sup> Although this bookkeeping requirement does involve some complexity, it should not be unduly burdensome for mutual funds to provide their shareholders with the necessary information, and it should ensure that taxpayers have no difficulties in completing their returns.

After having considered the reasons for the enactment of the Amendment and after having evaluated the effects of the Amendment on the state income tax with respect to fundamental principles of tax policy, the decision whether conformance to the Amendment is consonant with state tax policy can be made on a principled basis. In summary, the primary reason for the enactment of the Amendment, to broaden the municipal bond market, has little force on the state level,<sup>103</sup> whereas the secondary reason for the Amendment, to remove an inconsistency in the tax treatment of regulated investment companies, retains its validity on the state level.<sup>104</sup> Absolute conformance to the Amendment would result in an exemption for all exempt-interest dividends regardless of the state of the issuer. In view of the current exemption for interest on only Maryland municipal bonds, an exemption for all interest-dividends would be inconsistent with the principle underlying

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amendments was reflected by the broad differences between the two laws. Note, *Utah's Proposed Federally-Based Individual Income Tax Act*, 1971 UTAH L. REV. 493, 493-94.

101. MD. ANN. CODE art. 81, § 280(b)(1) (Cum. Supp. 1977).

102. In the administration of the Maryland Income Tax Law and where circumstances warrant, the [Income Tax Division] may request from the taxpayer or the fund proper verification and substantiation as to the nature and the identity of the State and local securities which are the basis for the claimed exempt status.

Income Tax Division Memorandum Release No. 17, 1 MD. TAX REP. (CCH) ¶ 11-305.25 (Feb. 10, 1977).

103. See text accompanying notes 85 to 87 *supra*.

104. See text accompanying note 88 *supra*.

the taxation of regulated investment companies that a shareholder of an investment company should be treated as if he owned directly his pro rata share of the securities held by the company. Within the current framework, this principle requires an exemption for only those exempt-interest dividends attributable to Maryland bonds.<sup>105</sup> Although it would be simpler to exempt all interest-dividends in conformance with the Amendment than to continue the current policy, taxing all interest-dividends would be virtually as simple. Moreover, the current exemption for only those interest-dividends attributable to Maryland bonds should not create any substantial difficulties for Maryland taxpayer compliance or for the administration of the tax laws. Furthermore, an exemption for all exempt-interest dividends would have a revenue cost associated with it that is not justified by any countervailing state policy.

In view of these considerations, it should be apparent that an exemption for all exempt-interest dividends in conformance with the Amendment would not be most consonant with Maryland tax policy. The Amendment presents one of the rather rare instances where an exception to the general rule of conformity to the Internal Revenue Code is justified. A choice should be made between the remaining alternatives of either continuing the current exemption for interest-dividends attributable to Maryland bonds, in partial conformance with the Amendment, or taxing all exempt-interest dividends, which would involve a complete rejection of the Amendment. While the policy of taxing all exempt-interest dividends would be simpler than the current policy and would produce some additional revenues, consistency with the conduit treatment of regulated investment companies requires an exemption for interest-dividends attributable to Maryland bonds. Although the balance between these considerations does not decidedly favor one alternative or the other, the benefits to be gained by taxing all exempt-interest dividends appear to be slightly outweighed by the inconsistency involved in doing so. Therefore, the current exemption for only those interest-dividends attributable to Maryland bonds should be continued.

#### CONCLUSION

In most instances, there will be a readily apparent answer to the question whether the impact of an amendment to the Internal Revenue Code on the state income tax warrants an exception to the general rule of conformity to the Code.<sup>106</sup> Nevertheless, this question must be asked by the state legislature for every amendment to the Code if the goal of a rational and coherent state income tax system is to be reached in other than a haphazard manner. In answering this question, consideration should be given to the same principles of tax policy that have long been applied to federal tax laws. Such scrutiny is necessary if for no other reason than for

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105. See text accompanying notes 93 to 96 *supra*.

106. See, *e.g.*, note 14 *supra*.

the legislature to maintain full awareness of the changes in the state income tax brought about by amendments to the Code.<sup>107</sup>

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107. Although the focus of this Comment is on the state response to amendments to the Internal Revenue Code, the state legislature should not restrict its attention to Code amendments. If a substantial inequity exists in the state income tax, it should be eliminated. *See generally* text accompanying notes 80 to 83 *supra*.