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Dear _____ :

This letter responds to your letter of November 22, 2008 requesting information on the meaning of the phrase in § 1.312-6(b) of the Income Tax Regulations that, among the items entering into the computation of corporate earnings and profits is "income not taxable to the Federal Government under the Constitution."

The regulation does not further explain that phrase. However, the widely respected tax law treatise, Federal Income Taxation of Corporations and Shareholders by Boris Bittker and James S. Eustice, states (in par. 8.03(3)) that the phrase refers to interest on state and municipal obligations. This interest, which is generally excluded from gross income under § 103 of the Internal Revenue Code, was long considered nontaxable by the Federal Government under the Constitution because it was thought to be a tax on the state governments. That opinion was commonly held when § 1.312-6(b) of the regulations was published in 1955. However, the Supreme Court in 1988 held that this exclusion was not constitutionally required, and that a prior Supreme Court decision that required the exclusion had been effectively overruled by later decisions. The 1984 decision held that an amendment to § 103 of the Code limiting the exclusion to bonds issued in registered form was constitutional. South Carolina v. Baker, 485 U.S. 505 (1988).

It should be noted that a later sentence in § 1.312-6(b) states that interest on state and local bonds that is nontaxable to the corporation is taxable to the same extent as other dividends when distributed to the corporation's shareholders.

We hope that this information is helpful.

Sincerely,

Mark Weiss
Assistant to the Chief, Branch 1
Office of Associate Chief Counsel
(Corporate)