Don’t Overlook the State Tax Exemption on U.S. Treasury Income—It Could Be Costly

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Key Takeaways

- Interest from direct U.S. Treasury obligations is generally exempt from state and local income taxes.
- A significant portion of income distributed by certain U.S. Treasury-focused ETFs may retain this state tax-exempt treatment.
- Reviewing the WisdomTree annual tax supplement report can help investors determine the appropriate state-level adjustment when filing taxes.

As interest rates have returned to more normal historical levels, many investors have increased exposure to high-quality fixed income strategies, including ETFs that hold U.S. Treasury securities. Certain fixed income ETFs may allocate to U.S. Treasury bills, notes and bonds either as primary holdings or as part of a broader bond allocation.

However, one structural characteristic is sometimes overlooked: income derived from direct U.S. Treasury obligations is generally exempt from state and local income taxes. For investors holding Treasury-focused ETFs in taxable accounts, understanding this distinction can help improve after-tax income and avoid unnecessary tax drag.

How State Tax Treatment Works

Interest earned on direct obligations of the U.S. government (such as U.S. Treasury bills, notes and bonds) is subject to federal income tax but is **generally exempt from state and local income tax**.

When an ETF earns income from these securities, the exempt character of that income may flow through to investors. However, this does not necessarily mean the exemption is automatically reflected in the tax statements (for example, Form 1099-DIV) that the investor receives from their broker through which they purchased the ETF shares.

As a result, investors may need to make adjustments when preparing their state income tax returns.

Where to Find the Relevant Information

WisdomTree publishes an annual tax supplement report that details the percentage of income derived from direct U.S. government obligations for each WisdomTree ETF.

In the report on the **"Secondary Layout"** tab under the column heading entitled **"% of Income From Federal Securities"**, this report provides the percentage of income attributable to direct U.S. Treasury obligations for each WisdomTree ETF and may assist investors in determining potential state tax adjustments.

Illustrative Example: The WisdomTree Floating Rate Treasury Fund

Assume an investor received $1,000 of ordinary income distributions from the WisdomTree Floating Rate Treasury Fund (USFR) during the tax year. According to the applicable annual tax supplement report, approximately 99.95% of USFR's ordinary income was derived from direct U.S. Treasury obligations.

Based on that percentage, approximately $999.50 of the $1,000 distribution may qualify for exemption from state and local income taxes, subject to state-specific requirements.

If the investor reports the full $1,000 as state-taxable income without adjustment, they could pay more in state income taxes than required.

Practical Considerations at Tax Time

Investors holding WisdomTree fixed income ETFs in taxable accounts may consider the following steps:

While the percentage of income attributable to federal securities can vary from year to year, incorporating this review into the annual tax process can help ensure accurate reporting.

- Review total ordinary income reported on Form 1099-DIV.
- Consult the WisdomTree ETF annual tax supplement report for the percentage attributable to direct U.S. Treasury obligations.
- Confirm how their state treats income from U.S. government obligations.
- Tax laws can be complex. Investors should consult a qualified tax professional regarding any necessary state adjustments and their specific situation.

Bringing Tax Awareness into Portfolio Decisions

A substantial portion of income distributed from certain WisdomTree fixed income ETFs may qualify for exemption from state and local income tax if it is derived from direct U.S. Treasury obligations. For Treasury-focused ETFs, reviewing the percentage of income derived from direct U.S. government obligations may help avoid unnecessary tax drag and enhance overall portfolio efficiency.

Important Risks Related to this Article

There are risks associated with investing, including possible loss of principal. Securities with floating rates can be less sensitive to interest rate changes than securities with fixed interest rates, but may decline in value. Fixed income securities will normally decline in value as interest rates rise. The value of an investment in the Fund may change quickly and without warning in response to issuer or counterparty defaults and changes in the credit ratings of the Fund's portfolio investments. Due to the investment strategy of this Fund it may make higher capital gain distributions than other ETFs. The Fund invests in the securities included in, or representative of, its Index regardless of their investment merit, and the Fund does not attempt to outperform its Index. Please read the Fund's prospectus for specific details regarding the Fund's risk profile.

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