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Date:March 31, 2005

Legend

Fund =

Trust =

State =

Year 1 =

X =

Dear :

This responds to your letter dated November 29, 2004, submitted on behalf of Fund by its authorized representative. Fund requests a ruling that for purposes of determining qualification as a regulated investment company ("RIC") under section 851(b)(3) of the Internal Revenue Code of 1986 (the "Code"), Fund should treat a particular sub-fund of State's Highway Fund, known as the "Infrastructure Fund," as the "issuer" of certain special obligation bonds described in this letter.

FACTS

Fund is an open-end management investment company, registered under the Investment Company Act of 1940,15 U.S.C. 80a-1 et seq., as amended (the "1940 Act"). Fund has qualified and elected to be a RIC under subchapter M, part I, of the Code. Fund is a series of Trust, an open-end management investment company

created under an initial declaration of trust, and is taxable as a separate corporation pursuant to section 851(g) of the Code.

Fund is a “money market fund” under relevant securities laws. See 17 CFR 270.2a-7 (“Rule 2a-7”). It invests at least x% of its assets in tax-exempt municipal securities of State that are exempt from both federal as well as State income taxes. Fund distributes its tax-exempt interest income to its shareholders as exempt-interest dividends under section 852(b)(5)(B) of the Code.

As a money market fund subject to Rule 2a-7 under the 1940 Act, Fund faces strict limitations on the credit quality and maturity of securities that it may purchase. A money market fund such as Fund, which invests largely or exclusively in the securities of a particular state, may find it difficult to obtain a sufficient supply of high credit quality, short-term investments.

Fund intends to invest in Special Obligation Revenue Bonds (“Bonds”) that were issued by State in Year 1. Bonds’ issuance is authorized by State’s law (“Special Obligation Act”) that authorizes State to issue State bonds in order to finance certain highway projects and transportation-related capital expenditures in State. Special Obligation Act provides that a portion of State’s gasoline tax (“Pledged Funds”) is to be diverted to a sub-fund of State’s Highway Fund known as the “Infrastructure Fund.”

Bonds were issued under a trust agreement (“Trust Agreement”) between State and a bank trustee (“Trustee”). Under the terms of Trust Agreement, State has covenanted that Pledged Funds will not be diverted for purposes other than those authorized by Special Obligation Act (“Authorized Purposes”). State has perfected a security interest in favor of Trustee, who may act on behalf of the holders of the Bonds (“Bondholders”) in the event that Pledged Funds are diverted from Infrastructure Fund for purposes other than Authorized Purposes. Pledged Funds are immune from State’s general creditors. Pledged Funds will be used first for debt servicing of Bonds, and only thereafter for capital expenditures on State’s highway projects, to the extent that any funds remain in Infrastructure Fund after all current payments due on Bonds have been made. Bonds are payable solely from, and are secured by a pledge of Pledged Funds; State did not pledge its full faith and credit to the payment of debt service on Bonds. Bondholders cannot look to any source other than Pledged Funds for repayment of their debt. This is in contrast to State’s general obligation bonds, for which State’s full faith and credit are pledged to the payment of the debt service.

LAW AND ANALYSIS

Section 851(b) of the Code provides that certain requirements must be satisfied for a domestic corporation to be taxed as a RIC under subchapter M, part I of the Code. Section 851(b)(3) imposes certain asset diversification requirements with respect to a RIC's total assets that must be satisfied as of the close of each quarter of the RIC's taxable year.

Section 851(b)(3)(A) requires that, in order for a corporation to qualify as a RIC, at the close of each quarter of the taxable year, at least 50 percent of the value of the corporation's total assets must be represented by cash and cash items (including receivables), Government securities, securities of other RICs, and other securities generally limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the corporation and to not more than 10 percent of the outstanding voting securities of such issuer.

Section 851(b)(3)(B) provides that, in order for a corporation to qualify as a RIC, not more than 25 percent of the corporation's total assets may be invested in the securities (other than Government securities and the securities of other RICs) of any one issuer, or of two or more issuers that the corporation controls and that are determined, under regulations, to be engaged in the same or similar trades or businesses or related trades or businesses.

Section 851(c)(5) provides that, for purposes of section 851(b)(3), all terms not specifically defined in section 851(c) shall have the same meaning as when used in the 1940 Act. Section 2(a)(22) of the 1940 Act defines “issuer” as “every person who issues or proposes to issue any security or has outstanding any security which it has issued.”

Rev. Proc. 2004-28, 2004-22 I.R.B. 984 states that the RIC diversification rules of subchapter M are substantially similar in structure and purpose to those of section 5(b)(1) of the 1940 Act. Both sets of rules impose numerical limitations on the percentages and types of assets that may be held by an investment company. Both sets of rules are intended to protect the investor from the risks of loss and of illiquidity inherent in the concentration of assets in the securities of a single or a small number of issuers. See H.R. Rep. No. 2020, 86th Cong., 2d Sess. 820--26. In view of the commonality of structure and purpose of both sets of rules and in view of the need for RICs simultaneously to comply with both, the RIC diversification provisions of the Code and those of the 1940 Act should be interpreted consistently. See also Rev. Rul. 2003-84, 2003-2 C.B. 289.

The SEC determines the issuer of a security for the purpose of administering diversification rules that are analogous to those of section 851(b)(3). Section 5(b)(1) of the 1940 Act defines a "diversified company" as a management company that has at least 75 percent of its assets invested in cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities that, for the purpose of this calculation, are limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the management company and to not more than 10 percent of the outstanding voting securities of the issuer. A money market fund such as Fund is permitted to satisfy an alternative diversification test under section (c)(4)of Rule 2a-7.

The SEC also interprets section 3 of the 1940 Act in order to determine the identity of the issuer of a security, in the context of the registration requirement for investment companies under the 1940 Act. An "investment company" is defined in section 3(a)(1) of the 1940 Act as an "issuer" that meets certain requirements.

The SEC staff has applied standards enunciated in Prudential Ins. Co. v.SEC, 326 F.2d 383 (3d Cir. 1964), aff'g In the Matter of Prudential Ins. Co., 41 S.E.C. 335 (1963), cert. denied, 377 U.S. 953 (1964) ("Prudential"), the seminal court case on point discussed below, when examining whether a separate issuer of a security exists for purposes of the registration requirement.

In Prudential, the court affirmed the SEC's ruling that a variable annuity separate account and its sponsoring insurance company were separate issuers for purposes of the registration requirement of the 1940 Act. The court applied a three-factor test in making its determination. Under the Prudential test, a separate issuer exists if (i) the entity causes interests to be issued in a pool of assets that is legally segregated from the entity's other assets; (ii) the assets in the pool are held primarily for the benefit of interest holders as the sole measure of their investment participation; and (iii) the interests in the pool do not confer significant rights in other assets of the entity.

Although arising in the context of the registration requirement of the 1940 Act, in order to reach its conclusion, the Prudential court examined the 1940 Act definitions of "company" and "issuer" that are also relevant here. Both Prudential and the subject case require a determination whether a "trust, a fund, or any other group of persons" may constitute an "issuer." If the three-part test enunciated in Prudential is applied to Bonds, then Infrastructure Fund should be viewed as the issuer of Bonds. State caused interests to be issued in a pool of assets that is legally segregated from the entity's other assets through Trust; the assets held in Trust are held primarily for the benefit of Bondholders and provide the sole measure of the success of Bondholders' investment; and, finally, Bondholders have no rights to any assets of State other than Pledged Funds.

The IRS explained the purpose of the diversification rules set out in section 851 of the Internal Revenue Code of 1954 in Rev. Rul. 76-392, 1976-2 C.B. 249:

> The diversification requirements of section 851 are designed to prevent regulated investment companies from concentrating their investment assets in a small number of companies or in certain forms of assets.

Similarly, the purpose of section 5(b)(1) of the 1940 Act is to ensure that registered investment companies that describe themselves to investors as having a "diversified" portfolio are in fact adequately diversified. See Hearings before the Subcommittee of the Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess. 188 (1940).

In the present situation, Fund acquired Bonds that were issued nominally by State, the proceeds of which are exclusively dedicated to finance State's highway projects. Interest and principal are payable solely out of Infrastructure Fund, which has been legally segregated from State's other assets. Thus, for purposes of section 851(b)(3), Infrastructure Fund should be treated as the issuer of Bonds.

CONCLUSION

Based on the information and representations submitted, we rule that for purposes of determining its qualification as a RIC under section 851(b)(3) of the Code, Fund should treat Infrastructure Fund as the "issuer" of Bonds.

Except as specifically ruled upon above, we express no opinion on the federal tax consequences of the transactions described above under any other provisions of the Code and regulations.

No opinion is expressed concerning whether Fund otherwise qualifies as a RIC under subchapter M, part I of the Code.

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Susan Thompson Baker
Assistant to the Branch Chief
Office of Associate Chief Counsel
(Financial Institutions & Products)