Internal Revenue Service

Department of the Treasury
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Person To Contact:
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CC:FIP:2
PLR-144720-06

Date:
December 5, 2007

Legend

Fund 1 =

Fund 2 =

Fund 3 =

Fund 4 =

Funds 1 through 4 =

Fund 5 or

Tax-Exempt Fund =

Former Adviser =

Former Affiliate =

Transfer Agent 1 =

Transfer Agent 2 =

Distribution Plans =

Order =

Dear :

This responds to your request dated September 22, 2006, and supplemental correspondence dated April 2, 2007, May 17, 2007, September 25, 2007, September 28, 2007, October 30, 2007, October 31, 2007, and November 29, 2007, submitted on behalf of Funds 1 through 5 (each a "Fund" and, collectively, "Funds") by your authorized representative. You request that the Internal Revenue Service rule as follows: First, that payments made to each of the Funds pursuant to the Distribution Plans will constitute qualifying income for purposes of section 851(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code") and second, that the allocation of these payments among the Funds' classes of shares as provided in the Distribution Plans will not result in preferential dividends under section 562(c).

FACTS

Each Fund is registered as an open-end management investment company under the Investment Company Act of 1940, 15 U.S.C. §80a-1 et seq., as amended (the "1940 Act"). Each Fund is classified as a domestic corporation for federal income tax purposes and has elected to be treated as a regulated investment company (RIC) under section 851 of the Code.

Each Fund has three or more classes of shares that have different arrangements for shareholder services or the distribution of shares or both. Funds represent that these arrangements satisfy the requirements of Rule 18f-3 of the 1940 Act and that the classes of shares constitute "Qualified Groups" of shares within the meaning of Rev. Proc. 99-40, 1999-2 C.B. 565.

Under these arrangements, each class of shares in each Fund is specially allocated the fees and expenses associated with shareholder servicing and distribution of shares of that class. Each class of shares also is specially allocated certain other fees and expenses, such as transfer agency fees, on the basis of amounts actually incurred by that class. Investment advisory fees and custodial fees are not specially allocated among the classes but rather are allocated based on the relative net asset value of each class of shares.

Former Adviser is registered with the SEC as an investment adviser and served as such to the Funds during the period covered by the Order. Former Affiliate is an affiliate of Former Adviser and is registered with the SEC as an investment adviser and broker-dealer.

Transfer Agent 1 initially provided transfer agency services directly to Funds. Funds' business was highly profitable to Transfer Agent 1 during this initial period as a result of a favorable fee schedule and the relatively low cost of servicing Funds.

The Order finds that Former Adviser, in the course of a review of transfer agent options, recommended to Funds' Boards of Directors that Transfer Agent 1 be replaced with Transfer Agent 2, an affiliate of Former Adviser, who would undertake to provide transfer agency services to Funds more economically. The Boards of Directors of Funds adopted this recommendation. Transfer Agent 2 then subcontracted with Transfer Agent 1 to perform substantially the same work it had previously performed, but at a significant discount from the fees it had previously charged Funds. Transfer Agent 2 provided a customer service call center and provided oversight and quality control over the work of Transfer Agent 1.

The Order further finds that, while offering Funds a limited fee reduction through the institution of fee caps, Former Adviser retained the majority of the savings it had

negotiated with Transfer Agent 1. The Order therefore finds that Transfer Agent 2 earned net fees far in excess of costs for the period covered by the Order.

The Order further finds that Former Adviser and Former Affiliate willfully violated certain provisions of the Investment Advisers Act of 1940, as amended (the "Advisers Act") by failing to disclose to the Boards of Directors of Funds, when proposing the new transfer agency arrangement with its affiliate Transfer Agent 2, that Transfer Agent 1 had offered to continue as transfer agent at a substantially lower fee. Also undisclosed to the Boards of Directors was (1) a side letter entered into between Former Adviser, Former Affiliate, and Transfer Agent 1 under which Former Adviser agreed to recommend the appointment of Transfer Agent 1 as sub-transfer agent to Transfer Agent 2 in exchange for a guarantee by Transfer Agent 1 of specified amounts of asset management and investment banking fees to Former Adviser and Former Affiliate, respectively, and (2) the fact that Transfer Agent 2 would earn a large profit while performing only limited functions while Transfer Agent 1 continued to perform substantially all transfer agency functions.

Although Former Adviser and Former Affiliate did not admit or deny any wrongdoing or liability, the Order provides for the imposition of sanctions on Former Adviser and Former Affiliate, including the payment to Funds of certain escrowed transfer agency fees. Under the terms of the Order, Transfer Agent 2 was required to escrow all transfer agency fees received from Funds throughout the remaining term of its contracts, less any payments made to sub-transfer agents and actual operational costs and expenses. From these escrowed amounts, Former Adviser and Former Affiliate were required to make distributions to Funds in amounts equal to the difference between the amounts actually paid by Funds for transfer agency services and the amounts that Funds would have paid under the new transfer agency contract had the new contract been in effect during the escrow period.

The Order additionally requires Former Adviser and Former Affiliate to pay disgorgement, prejudgment interest, and civil money penalties. Credited against the total amount of required disgorgement were previous payments that represented the amount generated under the side letter revenue guarantee. A further amount was credited against prejudgment interest; the remaining amount of disgorgement, which relates to profits earned by Transfer Agent 2 from Funds, plus an amount of prejudgment interest, was required to be paid to the United States Treasury. Additionally, Former Adviser was required to pay civil money penalties to the United States Treasury. Former Adviser and Former Affiliate agreed that, in any related investor action, they would not benefit from any offset or reduction of any investor's claim by the amount of any Fair Fund distribution to such investor that is proportionately attributable to the civil penalty.

The Order provides that a Fair Fund be established pursuant to section 308(a) of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, for the amounts paid by Former

Adviser and Former Affiliate. The disgorgement, prejudgment interest, and civil money penalty amounts were paid to the SEC and transferred to a fund (the "Fair Fund") established under the terms of the Order. Upon the SEC's approval of the proposed distribution plan, the amounts in the Fair Fund are to be returned to Former Adviser and Former Affiliate for distribution in accordance with the plan. Plans for the distribution of these amounts await SEC approval.

The Distribution Plans set forth a calculation of amounts paid to each of the Funds entitled to share in the distributed amounts on a class by class basis, that is, by treating each class of shares in a Fund entitled to share in the distributed amounts as a separate fund and separately determining the distributable amount for each class.

Funds distribute all their investment company taxable income (ICTI) and net exempt-interest income each year. On their Federal income tax returns for the years in which Funds incurred transfer agency fees, Funds 1 through 4 (the) deducted these fees in computing ICTI. Fund 5 was generally unable to deduct transfer agency fees pursuant to section 265(a)(3) of the Code. To the extent, however, that Fund 5 recognized taxable ordinary income, such as market discount on tax-exempt obligations, it deducted a portion of the transfer agency fees against that gross income. Non-deductible transfer agency fees were taken into account in determining the amount of Fund 5's exempt-interest dividend payments under section 852(b)(5)(A). A portion of Fund 5's tax-exempt income was treated under section 57(a)(5) as a tax preference for alternative minimum tax purposes.

Funds seek a ruling that all amounts received by Funds pursuant to the Escrow Distribution Plan and Fair Fund Distribution Plan, whether categorized as escrowed transfer agency fees, disgorgement, prejudgment interest, penalty, or earnings on the foregoing, constitute qualifying income to Funds under section 851(b)(2) of the Code. Funds further seek a ruling that the allocation of these distributions among the classes of shares within each Fund will not result in preferential dividends under section 562(c).

LAW AND ANALYSIS

Ruling Request (1): Payments made to Funds pursuant to the Escrow Distribution Plan and the Fair Fund Plan will constitute qualifying income for purposes of section 851(b)(2).

Section 851(a) of the Code defines a RIC, in part, as a domestic corporation registered under the 1940 Act as a management company.

Section 851(b) of the Code limits the definition of a RIC to a corporation meeting certain election, gross income, and diversification requirements.

Section 851(b)(2) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it derives at least 90 percent of its gross income from certain enumerated sources (qualifying income). In 1986 Congress amended section 851(b)(2) to include as qualifying income other income derived with respect to a RIC's business of investing in stock, securities, or currencies (the "other income" clause). Section 851(b)(2) now defines qualifying income, in relevant part, as—

> dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the 1940 Act) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [the RIC's] business of investing in such stock, securities, or currencies . . . .

Section 851(b) further provides that, for purposes of section 851(b)(2) of the Code, amounts excludable from gross income under section 103(a) shall be treated as included in gross income.

Section 852(b)(5) of the Code permits a RIC that holds at least 50 percent of the value of its total assets in obligations described in section 103(a) to designate and pay exempt-interest dividends in accordance with the requirements of section 852(b)(5)(A). Section 852(b)(5)(B) provides that an exempt-interest dividend is treated by the RIC's shareholders as an item of interest excludable from gross income under section 103(a).

Taxable Funds

In Rev. Rul. 92-56, 1992-2 C.B. 153, the Service concluded that a reimbursement of advisory fees paid in a prior year and received by a RIC from its investment advisor in the normal course of business and not as a result of a transaction entered into to artificially inflate the RIC's qualifying gross income was qualifying income under the other income clause of section 851(b)(2) of the Code.

Recoveries of overcharged transfer agency fees received by Funds pursuant to the Distribution Plans are similar to the reimbursed advisory fees described in Rev. Rul. 92-56. Both transfer agency services and investment advisory services are incurred in the normal course of Funds' business of investing in stock, securities, and currencies. Recovery of overcharges of fees for these services undertaken through litigation or settlement relates directly to this normal course of business. Similarly, penalty amounts arising out of the overcharge of transfer agency fees are directly attributable to the recovery of compensation for the overcharged fees and thus to the conduct of Funds' normal course of business. Accordingly, we rule that recoveries of transfer agency fees and penalty amounts received by the Taxable Funds pursuant to the Distribution

Plans are qualifying income to the Taxable Funds under section 851(b)(2) of the Code. Amounts in the nature of interest received by the Taxable Funds pursuant to the Distribution Plans (including prejudgment interest, earnings on prejudgment interest, earnings on escrowed amounts, earnings on disgorgement, and earnings on penalty amounts) also constitute qualifying income under section 851(b)(2) because interest is expressly enumerated as a type of qualifying income in that section.

Tax-Exempt Fund

As ruled in a related letter (PLR-148672-06), amounts received as recoveries of overcharged transfer agency fees not deducted in the year in which they were incurred pursuant to section 265(a)(3) of the Code are not includible in gross income of the Tax-Exempt Fund in the year of recovery. The related letter further rules, however, that these recoveries of transfer agency fees may properly be constructively treated by the Tax-Exempt Fund as interest excludable from income under section 103(a), solely for purposes of ensuring that the Tax-Exempt Fund may designate these amounts as exempt-interest dividends in the year of recovery in accordance with section 852(b)(5) and for purposes of the determination of qualifying income under the flush language of section 851(b).

The flush language of section 851(b) provides that amounts excluded from gross income under section 103(a) shall be treated as included in gross income for purposes of section 851(b)(2) of the Code. We therefore rule that recoveries of transfer agency fees received by the Tax-Exempt Fund that are constructively treated as interest excludable from gross income under section 103(a) are treated as included in gross income for purposes of section 851(b)(2).

In accordance with the foregoing analysis of like amounts recovered by the Taxable Funds, we further rule that recoveries of transfer agency fees, amounts in the nature of interest (including prejudgment interest, earnings on prejudgment interest, earnings on escrowed amounts, earnings on disgorgement, and earnings on penalty amounts), and penalty amounts received by the Tax-Exempt Fund pursuant to the Distribution Plans are qualifying income to the Tax-Exempt Fund under section 851(b)(2) of the Code.

Ruling Request (2): Allocation of distributions received by Funds pursuant to the Distribution Plans to share classes within each Fund as provided in the Distribution Plans will not result in preferential dividends under section 562(c).

The Distribution Plans provide for an allocation of distributions of recovered transfer agency fees, interest, and penalty amounts among the classes of shares of each Fund. Under the Fair Fund Plan, the calculation of

amounts to be distributed to each class is to be made based on the ratio of the transfer agency fees paid by each class to the total transfer agency fees paid by all classes. Under the Escrow Plan, a similar calculation is to be made based on the ratio of the savings that each class would have realized from the retroactive application of the new transfer agency fee rate during the escrow period to the total transfer agency fee savings that would have been realized during this period by all classes of shares.

Rev. Proc. 99-40, 1999-2 C.B. 565, describes conditions under which distributions made to shareholders of a RIC may vary and nevertheless be deductible as dividends under section 562 of the Code. Section 3.02 of this revenue procedure describes allocations of fees or expenses incurred by a RIC meeting the requirements of the revenue procedure to its qualified groups of shares. Under this section, a different share of fees and expenses (not including advisory or custodial fees or the fees related to the management of the RIC's assets) that are actually incurred in different amounts by a qualified group of shares, or are incurred for services of a different kind or to a different degree than other qualified groups, may be allocated to that qualified group of shares of a RIC that meets the requirements of the revenue procedure. Funds represent that Funds meet all requirements of Rev. Proc. 99-40 and that recoveries of overcharged transfer agency fees under the Distribution Plans are allocated as described in section 3.02 of that procedure.

Section 4.02 of Rev. Proc. 99-40 addresses allocations of waivers or reimbursements of fees and expenses described in section 3.02 of the procedure. If, as Funds represent, the fee or expense was originally allocated on the basis of the amount incurred on behalf of each qualified group of shares, this section provides that the benefit of a waiver or reimbursement of the fee or expense is to be allocated to the qualified group of shares on behalf of which the expense was incurred. Because reimbursements of transfer agency fees recovered under the Plans are to be allocated to each class of shares of Funds on the basis of the amount of transfer agency fees originally incurred by and allocated to each class of shares, the reimbursements are allocated consistently with the method of allocation of waivers and reimbursements described in section 4.02 of Rev. Proc. 99-40. In accordance with that procedure, we therefore rule that allocations of reimbursements of transfer agency fees recovered under the Distribution Plans by Funds do not result in preferential dividends under section 562(c) of the Code. We rule further that, although not described in this revenue procedure, related and corresponding allocations of amounts recovered in the nature of interest and as penalties among the classes of shares of Fund in a manner consistent with Rev. Proc. 99-40 do not give rise to preferential dividends.

No opinion is expressed or implied concerning the federal income tax consequences of the transaction described in this letter, except as expressly provided.

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

A copy of this letter should be attached to the federal income tax return of a Fund for each taxable year in which it receives recoveries of transfer agency fees, amounts in the nature of interest, and penalty amounts pursuant to the Order and in which it makes distributions to its shareholders pursuant to the Distribution Plans as described in this letter. Alternatively, a Fund filing its income tax return electronically may satisfy this requirement by attaching a statement to its return that provides the date and control number of this letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Susan Thompson Baker
Susan Thompson Baker
Assistant to the Branch Chief, Branch 2
Office of the Associate Chief Counsel
(Financial Institutions & Products)