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Washington, DC 20224

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Refer Reply To:
CC:ITA:3
PLR-148672-06

Date:
December 05, 2007

Legend

Taxpayer =

Former Adviser =

Former Affiliate =

Transfer Agent 1 =

Transfer Agent 2 =

Distribution Plans =

Order =

x =

$a =
$b =
$c =
$d =
$e =
$f =
$g =
$h =
Month/Day =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

Dear :

This letter responds to a ruling request submitted on behalf of Taxpayer by a letter dated October 12, 2006, and supplemented by correspondence dated April 2, 2007; May 17, 2007; September 25, 2007; September 28, 2007; October 30, 2007; October 31, 2007; and November 29, 2007. The ruling request relates to the tax treatment of the amounts received pursuant to the Distribution Plans.

FACTS

Taxpayer 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"). Taxpayer is classified as a domestic corporation for federal income tax purposes and has elected to be treated as a regulated investment company (RIC) under § 851 of the Internal Revenue Code (the Code).

Taxpayer uses the accrual method of accounting and files its federal income tax returns on the basis of a fiscal year ending on Month/Day. Taxpayer invests primarily in municipal securities or other investments with similar economic characteristics, the income from which is exempt from regular federal income tax. At the close of each quarter of each of Taxpayer's taxable years ending prior to the date of this letter ruling, at least 50% of the value (as defined in § 851(c)(4) of the Code) of Taxpayer's total assets consisted of obligations described in § 103(a) of the Code. Taxpayer represents that at the close of each quarter of each taxable year that ends after the date of this letter ruling and during which it receives an amount pursuant to the Distribution Plans, at least 50% of the value (as defined in § 851(c)(4)) of Taxpayer's total assets will consist of obligations described in § 103(a).

Taxpayer has x classes of shares that represent interests in the same portfolio of securities but have different arrangements for shareholder services and the distribution of shares. Taxpayer represents 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 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 Taxpayer and other RICs (collectively "the Funds" and individually "a Fund") 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 the Funds. The 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 the Funds.

The Order finds that Former Adviser, in the course of a review of transfer agent options, recommended to the 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 the Funds more economically. The Boards of Directors of the 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 the 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 the 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, 15 U.S.C. § 80b-1 et seq., as amended (the "Advisers Act") by failing to disclose to the Boards of Directors of the

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 the 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 the 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 the Funds in amounts equal to the difference between the amounts actually paid by the Funds for transfer agency services and the amounts that the Funds would have paid under the new transfer agency contract had the new contract been in effect during the escrow period. The escrow arrangement covered transfer agency fees for the period from Date 1 through Date 2. The amount of $a was deposited into escrow and placed in certain investments. Distributions were made to the Funds on a class by class basis, that is, by treating each class of shares in a Fund entitled to share in the escrowed amounts as a separate fund and separately determining the distributable amount for each class. Distributions were made on Date 3 and Date 4.

The Order additionally requires Former Adviser and Former Affiliate to pay disgorgement, prejudgment interest, and civil money penalties. The Order requires Former Adviser and Former Affiliate to pay disgorgement in the amount of $b, plus prejudgment interest of $c. Credited against the total amount of required disgorgement were previous payments totaling $d, which represents the amount generated under the revenue guarantee in the side letter; $e was credited against prejudgment interest of $c. The remaining $f of disgorgement, which relates to profits earned by Transfer Agent 2 from the Funds between Date 5 and Date 6, plus prejudgment interest of $g, was required to be paid to the United States Treasury. Additionally, Former Adviser was required to pay civil money penalties of $h 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 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 will be returned to Former Adviser and Former Affiliate for distribution in accordance with the plan.

The proposed distribution plan for distribution of disgorgement, prejudgment interest, and penalties, as well as earnings on the foregoing, awaits SEC approval. As presently proposed, distributions will be made to the Funds 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.

Taxpayer distributes all of its investment company taxable income (ICTI) and net exempt-interest income each year. On its federal income tax returns for the years in which it incurred transfer agency fees, Taxpayer was generally unable to deduct transfer agency fees pursuant to § 265(a)(3) of the Code. To the extent, however, that Taxpayer 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 Taxpayer's exempt-interest dividend payments under § 852(b)(5)(A). A portion of Taxpayer's tax-exempt income was treated under § 57(a)(5) as a tax preference for alternative minimum tax purposes.

LAW AND ANALYSIS

With respect to the escrow arrangement, the distributions made on Date 3 and Date 4 are recoveries of transfer agency fees incurred during the period from Date 1 through Date 2 to the extent they are a return of amounts held in escrow, and the distributed earnings on those amounts are gross income under § 61 of the Code. The tax treatment of recoveries of transfer agency fees is discussed below.

With respect to the proposed distribution plan, distributions attributable to the $f are recoveries of transfer agency fees incurred during the period from Date 5 through Date 6. Distributions attributable to amounts in excess of $f – whether designated as prejudgment interest, penalty, or some other amount – are gross income under § 61.

<u>Issue 1 – Does Taxpayer have gross income from the recovery of transfer agency fees incurred during prior years?</u>

<u>Issue 1(a) -- Does Taxpayer have gross income from the recovery of transfer agency fees that were deducted on a prior year's income tax return?</u>

Section 61(a) of the Code provides that, except as otherwise provided, gross income means all income from whatever source derived. The Supreme Court of the United States has stated that gross income includes any "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

Section 111(a) provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by chapter 1 of the Code.

Section 162(a) provides the general rule that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 265(a)(3) provides that in the case of a RIC that distributes during the taxable year an exempt-interest dividend (including exempt-interest dividends paid after the close of the taxable year under § 855), no deduction shall be allowed for that portion of any amount otherwise allowable as a deduction which the amount of the income of such company wholly exempt from income taxes bears to the total of such exempt income and its gross income (excluding from gross income, for this purpose, capital gain net income, as defined in § 1222(9)).

Generally, the tax benefit rule requires a taxpayer who received a tax benefit from a deduction in an earlier year to recognize income in a later year if there occurs an event that is fundamentally inconsistent with the premise on which the deduction was initially based. The term "tax benefit rule" encompasses two concepts, an inclusionary part and an exclusionary part. The inclusionary part has been developed in the courts and requires a taxpayer to include a previously deducted amount in the current year's income when a fundamentally inconsistent event has occurred. The exclusionary part is currently codified at § 111 and permits a taxpayer to exclude an amount that did not previously provide a tax benefit when it was deducted.

The tax benefit rule allays some of the inflexibilities of the annual accounting system under specific circumstances. Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc., 460 U.S. 370, 377 (1983). Its purpose is to approximate the results produced by a tax system based on transactional rather than annual accounting. Id. at 381. The tax benefit rule will "cancel out" an earlier deduction when the later event is fundamentally inconsistent with the premise on which the deduction was initially based, even if there is no actual recovery of funds. Id. at 381-383. One must consider the facts and circumstances of each case in light of the purpose and function of the provisions granting the deductions. Id. at 385. Although it is usually helpful to determine whether the later event would have foreclosed the deduction if it had occurred within the same tax year, that inquiry is not an exclusive test. See American Mutual Life Insurance Co. v. United States, 267 F.3d 1344, 1350 (Fed. Cir. 2001).

In earlier years, Taxpayer deducted (to the extent not disallowed by § 265(a)(3)) a portion of the transfer agency fees incurred during such years. Accordingly, the recovery of transfer agency fees is partially attributable to amounts deducted in prior years and amounts not deducted in prior years. To the extent a recovery is attributable to an amount deducted on a prior year's income tax return, such amount would be income under the tax benefit rule and subject to the provisions of § 111.

Issue 1(b) -- Does Taxpayer have gross income from the recovery of transfer agency fees that were not deducted on a prior year's income tax return?

The determination of whether the proceeds of a judgment or settlement of a lawsuit constitute income under § 61 depends on the nature of the claim and the actual basis for recovery. If the recovery represents damages for lost profits, it is taxed as ordinary income. If, however, the recovery is treated as a replacement of capital, the damages received from the lawsuit are treated as a return of capital and are not taxable as income. Freeman v. Commissioner, 33 T.C. 323 (1959). Payments by the one causing a loss that do no more than restore a taxpayer to the position he or she was in before the loss was incurred are not includible in gross income because there is no economic gain. Rev. Rul. 81-277, 1981-2 C.B. 14.

In this case, the payments that Taxpayer receives as a recovery of transfer agency fees will do no more than restore Taxpayer to its position before it incurred the overcharged fees. Thus, the payments do not give rise to an economic gain. Accordingly, the payments that Taxpayer receives as a recovery of transfer agency fees are not includible in income to the extent that Taxpayer did not deduct such fees in accordance with § 265(a)(3).

Issue 2 -- What is the character of the recovered transfer agency fees?

Issue 2(a) -- Should the taxable amounts be recharacterized with reference to the different types of income in the year of recovery?

Rev. Rul. 92-56, 1992-2 C.B. 153, holds that if, in the normal course of its business, a RIC receives a reimbursement from its investment advisor and the reimbursement is includible in the RIC's gross income, the reimbursement is qualifying income under § 851(b)(2). The revenue ruling does not specifically discuss the characterization of such a reimbursement. However, the following section of the revenue ruling, which discusses the effect on other revenue rulings, is relevant.

In Rev. Rul. 64-247, 1964-2 C.B. 179, a company recovered

> excess management fees from its investment manager. The recovery was made as a result of legal action brought against the company's former officers and directors who had owned the investment manager. In Rev. Rul. 74-248, 1974-1 C.B. 167, a company's former investment advisor paid the company an amount the advisor had improperly received for assigning its advisory contract. The payment was made pursuant to a settlement agreement that was reached after the company's shareholders filed a derivative action against the investment advisor. In both rulings, the payments were includible in the company's gross income. The rulings held that the payments did not cause the companies to fail to meet the definition of RIC contained in section 851 of the Code, provided the companies in all other respects qualified for RIC status for the taxable year in question. **The rulings also held that, for purposes of section 854, relating to limitations applicable to dividends received from RICs, the payments should be allocated between interest and dividends in proportion to the interest and dividends derived by the company during the taxable year in which the payments were includible in gross income.**
>
> Rev. Ruls. 64-247 and 74-248 predate the 1986 amendment of section 851(b)(2) of the Code, which specifies that qualifying income includes other income derived by a RIC with respect to its business of investing in stock, securities, or foreign currencies. See section 653 (b) and (d), Tax Reform Act of 1986, 1986-3 (Vol. 1) C.B. 215. Accordingly, Rev. Ruls. 64-247 and 74-248 are obsolete to the extent they imply that the payments therein would not be qualifying income under section 851(b)(2). **Rev. Ruls. 64-247 and 74-248 are also obsolete to the extent they would treat the payments, in part, as dividend income under section 854.**

(Emphasis added.)

The full meaning of the emphasized language quoted above can be determined by reviewing the version of § 854 that was in effect at the time Rev. Ruls. 64-247 and 74-248 were issued. At that time, § 854(b)(1)(B) required that the aggregate dividends received by a RIC during its taxable year be less than 75% of its gross income (excluding gain from the sale of stock or securities) for a distribution of dividends to its individual shareholders to be eligible for any exclusion under former § 116 and for a distribution of dividends to its corporate shareholders to be eligible for any deduction under § 243. If such distributions were eligible, the specific amount that qualified for exclusion or deduction was calculated by taking into account only that portion of the dividend that bears the same ratio to the amount of such dividend as the aggregate dividends received by the RIC during its taxable year bear to its gross income for the taxable year.

In Rev. Ruls. 64-247 and 74-248, the holding with respect to § 854 resulted in the payment having no effect on whether dividends distributed to the RIC's individual shareholders qualified for any exclusion under former § 116 or whether dividends distributed to corporate shareholders qualified for any deduction under § 243. Even though the RIC's gross income was increased by the full amount of the payment, the amount treated as aggregate dividends received by the RIC during its taxable year was increased by only a pro rata portion of the payment. As a result, to the extent that the payment to the RIC resulted in increased dividend distributions to its shareholders, such increase was only partially eligible for the exclusion under former § 116 and the deduction under § 243.

At the time Rev. Rul. 92-56 was issued, § 854(b)(1) of the Code still limited the aggregate amount that could be designated as dividends to the aggregate dividends received by the RIC for the taxable year. However, the 75% threshold requirement in old § 854(b)(1)(B), which was discussed above, was removed prior to the time Rev. Rul. 92-56 was issued.

In light of the amendments to § 851(b)(2) of the Code and the issuance of Rev. Rul. 92-56, we conclude that the taxable amounts should not be recharacterized with reference to the different types of income in the year of recovery.

Issue 2(b) -- Should the taxable amounts be recharacterized with reference to the different types of income in the years the transfer agency fees were incurred and deducted?

In earlier years, Taxpayer deducted (to the extent not disallowed by § 265(a)(3) of the Code) a portion of the transfer agency fees incurred during such years. Those deductions reduced Taxpayer's investment company taxable income in these earlier years. This income would have included any market discount on tax-exempt obligations, any dividends, or any taxable interest. The transfer agency fees deducted did not reduce net capital gain.

In Rev. Rul. 64-247, the taxpayer recovered amounts after bringing a legal action against certain of its former officers and directors to recover excess management fees paid to a corporation owned by the former officers and directors. For all its prior taxable years, the taxpayer qualified to be taxed as a regulated investment company under subchapter M, chapter 1, subtitle A of the Internal Revenue Code of 1954. Management fees were a type of expense deductible under § 162 in the prior years. Such an expense would have reduced income from any dividends, any taxable interest, and any excess of the net short-term capital gain over the net long-term capital loss. Under then § 852(b)(2), investment company taxable income did not include the excess of the net long-term capital gain over the net short-term capital loss.

The ruling held that the recovered amounts did not cause the taxpayer to fail to meet the definition of RIC contained in § 851, provided that in all other respects the taxpayer qualifies for RIC status for the taxable year in question. The ruling also held that, for purposes of § 854, relating to limitations applicable to dividends received from RICs, the recovered amounts should be allocated between interest and dividends in proportion to the interest and dividends derived by the taxpayer during the taxable year of the recovery. Implicit in that holding is a determination that the recovered amounts did not otherwise have a characterization besides generic ordinary income. The second holding of the revenue ruling, as well as the first, would have been stated differently if, absent the revenue ruling, the recovered amounts would have been characterized with reference to the different types of income in the years the management fees were deducted.

Rev. Rul. 64-247 was obsoleted by Rev Rul. 92-56. The term "obsolete" describes a previously published ruling that is not considered determinative with respect to future transactions. See 1992-2 C.B. iv. Rev. Rul. 64-247 was not revoked. The term "revoked" describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling. Id. Rev. Rul. 64-247 is still instructive because it was obsoleted and not revoked. Accordingly, we conclude that the taxable amounts should not be recharacterized with reference to the different types of income in the years the transfer agency fees were incurred and deducted. Taxpayer should treat these taxable amounts as ordinary non-dividend income for purposes of making designations with respect to dividends for the taxable year in which Taxpayer has income from the recovery of transfer agency fees.

Issue 3 – To the extent Taxpayer has a recovery of transfer agency fees that were not deducted on a prior year's return, are these amounts properly recharacterized as an amount of interest excludable from gross income under § 103(a) of the Code, in order that Taxpayer may designate these amounts as exempt-interest dividends under § 852(b)(5)(A) in the year of recovery?

Section 103(a) of the Code provides an exclusion from gross income for interest on any State or local bond, with certain exceptions. This exclusion benefits State and local governments by making financing available for governmental purposes at lower interest rates.

In structure and purpose, the RIC provisions of subchapter M of the Code generally are designed to ensure single-tier taxation of corporate income and gains from investment assets at the shareholder level. The exempt-interest dividend provisions of § 852(b)(5) extend this model to the tax-exempt interest arena.

Section 852(b)(5) permits a RIC that holds at least 50 percent of its assets in obligations described in § 103(a) to designate exempt-interest dividends to its shareholders. Taxpayer represents that it fulfilled this statutory requirement in the years of overcharge and will fulfill it during the years it receives any recovery.

Section 852(b)(5)(A) defines an exempt-interest dividend as any dividend or part thereof (other than a capital gain dividend) paid by a RIC and designated by it as an exempt-interest dividend in a written notice mailed to its shareholders not later than 60 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 § 855) is greater than the excess of --

> (i) the amount of interest excludable from gross income under § 103(a), over
>
> (ii) the amounts disallowed as deductions under §§ 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 amount of such excess for such taxable year bears to the amount so designated.

Subject to the conditions and limitations set forth in that section, § 852(b)(5) thus empowers a RIC that holds at least 50 percent of its assets in obligations described in § 103(a) to pass through the tax-exempt character of amounts received on these obligations to its shareholders. Enacted in 1976 to allow small investors in tax-exempt obligations the same benefits of diversification already afforded to investors in RICs holding equities and taxable debt securities, this section preserves the character of tax-exempt interest earned by a RIC in the hands of its shareholders.

As analyzed above under Issue 1(b), amounts Taxpayer receives as a recovery of transfer agency fees not deducted in the years of overcharge do no more than restore Taxpayer to its position before the overcharge, do not give rise to an economic gain, and are not includible in gross income under § 61 of the Code. These amounts therefore cannot be categorized as directly within the exclusion from gross income provided by § 103(a), and we do not so rule. Recharacterization of these amounts as described in the following sentence is consistent, however, with the purposes of §§ 103 and 852(b)(5). In order to give full effect to Congressional intent underlying the provisions of § 852(b)(5) and of subchapter M generally, we therefore rule that these amounts may properly be constructively treated by Taxpayer as interest excludable from gross income under § 103(a), solely for purposes of ensuring that Taxpayer as a RIC may designate these amounts as exempt-interest dividends in the year of recovery in accordance with § 852(b)(5) and for purposes of the determination of qualifying income under the flush language of § 851(b). Additionally, we rule that such amounts eligible for designation as exempt-interest dividends will be considered items of tax preference under § 57(a)(5) to the extent the transfer agency fees previously offset tax-exempt income that was treated as tax preference income under § 57(a)(5).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences, including the source of the recovered transfer agency fees for purposes of subchapter N, of any aspect of any transaction or item discussed or referenced in this letter.

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

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the 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,

Christopher F. Kane
Chief, Branch 3
Office of Associate Chief Counsel
(Income Tax and Accounting)