

**MEMO# 22610**

June 16, 2008

# **Treasury Guidance On Auction Rate Preferred Stock**

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 20-08  
TAX MEMBERS No. 23-08  
SEC RULES MEMBERS No. 50-08  
FIXED-INCOME ADVISORY COMMITTEE No. 14-08  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 13-08      RE: TREASURY GUIDANCE ON  
AUCTION RATE PREFERRED STOCK

The Treasury Department has issued the attached guidance addressing issues advanced by the ICI and others regarding auction rate preferred stock ("ARPS"). [\[1\]](#) Specifically, Notice 2008-55 provides that the Internal Revenue Service ("IRS") will not challenge the equity characterization of certain ARPS issued by closed-end funds and supported by a liquidity facility. One effect of this position is that dividends paid by a fund holding tax-exempt bonds, to shareholders of ARPS supported by a liquidity facility, will be treated as exempt-interest dividends (and exempt from Federal income tax as municipal bond interest pursuant to Code section 852(b)(5)).

The Notice emphasizes in several places that it has limited applicability. First, the guidance applies only if the specific conditions discussed in the Notice and summarized below are met. Second, as Treasury notes, the guidance has been issued to provide "administrative relief in furtherance of public policy in light of significant liquidity needs in the auction rate securities market as a result of recent significant auction failures in this market." Finally, the notice provides that no inferences should be drawn regarding any tax issue not addressed specifically by the Notice.

**Eligible Issuers.** The Notice applies only if the ARPS issuer is a closed-end management company that is treated for tax purposes as a regulated investment company ("RIC"). The fund's investments must be limited to tax-exempt and/or taxable debt instruments. The fund must issue its ARPS in the United States.

**Eligible ARPS.** To be eligible for the Notice's relief, the ARPS must have been outstanding on February 12, 2008 (the date on which significant auction failures first occurred) or issued after that date to refinance (directly or indirectly) ARPS outstanding on that date. The amount of ARPS that can be issued pursuant to a refinancing is limited to the amount of the previously-outstanding ARPS' liquidation preferences.

**Payment of Dividends by Issuer.** Any dividend paid on ARPS must be duly declared and paid only out of legally-available funds (as provided by applicable state law).

**Liquidity Facility Arrangement.** The liquidity facility arrangement covered by the Notice involves an agreement by the liquidity provider to purchase ARPS from holders, including money market funds, for the stock's liquidation preference plus accrued but unpaid dividends. The liquidity provider's obligation to purchase ARPS is triggered by either of two events ("trigger events"). The first trigger event occurs if an auction or remarketing fails. The second trigger event occurs if an existing liquidity facility is not renewed, replaced, or extended with either the same liquidity provider or another liquidity provider by a date that occurs at least two auction or remarketing dates before the stated expiration date of the existing liquidity facility then in place.

**Eligible Liquidity Facility.** The liquidity facility must be either (1) an initial liquidity facility with respect to the ARPS that is entered into after February 12, 2008 and on or before December 31, 2009 or (2) a liquidity facility that renews, replaces, or extends such an initial liquidity facility, either directly or in a series of liquidity facilities. In addition, the liquidity provider cannot be "related" to the issuer of the ARPS (as determined before taking into account any purchase of ARPS by the liquidity provider under the liquidity facility).

**Redemption by Issuer of ARPS Held by Liquidity Provider.** If the agreement between the issuer and the liquidity provider gives the liquidity provider a right to have the ARPS redeemed, the right cannot be exercised until the ARPS have been held by the liquidity provider for at least one year and only after continuous good faith efforts to resell the stock in the periodic auctions (at a price equal to the liquidation preference plus accrued but unpaid dividends). Moreover, any redemption right provided to the liquidity provider by contract must be limited by applicable state law restrictions on redemptions of stock that apply to any ARPS holder (e.g., state law restrictions on redemptions of stock which would impair the issuer's required capital, surplus, or total assets).

Certain Liquidating Partnerships that hold ARPS. The Notice also provides that IRS will not challenge the equity characterization of interests in a partnership as a result of adding a liquidity facility to support the variable-rate interests in the partnership. The relief applies only if, among other things, at least 95 percent of the partnership assets are ARPS.

Keith Lawson  
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[Attachment](#)

#### **endnotes**

[\[1\]](#) The staff of the Securities and Exchange Commission also has issued guidance, in the form of no-action relief, on liquidity protected preferred shares. See Eaton Vance Management, SEC No-Action Letter (June 13, 2008).

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