

**MEMO# 8650**

February 20, 1997

## **MULTIPLE-CLASS FUNDS -- IRS QUESTIONS ON PERFORMANCE BASED ADVISORY FEES**

1 See Institute Memorandum to Accounting/Treasurers Members No. 25-96 and Tax Members No. 43-96, dated September 10, 1996. 2 See Institute Memorandum to Accounting/Treasurers Committee No. 47-96 and Tax Committee No. 36-96, dated November 26, 1996. ACTION REQUESTED February 20, 1997 VIA FAX TO: TAX COMMITTEE No. 6-97 RE: MULTIPLE-CLASS FUNDS -- IRS QUESTIONS ON PERFORMANCE BASED ADVISORY FEES

As you may recall, last fall the IRS requested comments on the preferential dividend implications for multiple-class mutual funds of variations in distributions among classes that are due to allocations of differing investment advisory fees under a performance-based fee contract.<sup>1</sup> Under Rule 18f-3, the SEC requires that the investment advisory fee charged to each class be the same percentage amount, but allows the percentage amount to vary for each class if the difference is the result of the application of the same performance fee provision in the advisory contract to the different performances of each class (a "performance-based fee"). The Institute's submission to the IRS in response to the request for comments analyzed the treatment of performance-based fees under the preferential dividend rules and concluded that permitting such fees would be consistent with the relevant tax policies.<sup>2</sup> In a meeting with IRS representatives to discuss the Institute's submission, the IRS raised the following questions on performance-based fees: 1. Can a performance-based fee have a net negative effect on the return to a fund or a class? In other words, can a fee increase under a performance-based fee arrangement exceed the higher performance that generated the higher fee? 2. For purposes of calculating a performance-based fee, must the fund's (or a class') performance be calculated by taking into account all expenses, or is it permissible to take into account only certain expenses? Alternatively, can a performance-based fee be calculated on a gross basis, i.e., before expenses are taken into account? 3. The IRS' current ruling position permits pro rata waivers and reimbursements of advisory fees. How would a pro rata waiver or reimbursement of a performance-based fee be accomplished -- would pro rata require the same number of basis points for each class, or the same percentage of the advisory fee for each class? In order to help us respond to the IRS' questions, we would appreciate any comments you may have regarding the questions. We will need to receive any comments by Monday, February 24. Please call the undersigned at (202) 326-5837 with any comments. Thank you. Anne M. Barr Associate Counsel - Tax

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