MEMO# 6089

July 27, 1994

TREATMENT OF CERTAIN TAX-EXEMPT NOTES UNDER IRS RULES

July 27, 1994 TO: MONEY MARKET FUNDS AD HOC COMMITTEE NO. 16-94 MONEY MARKET MEMBERS - ONE PER COMPLEX NO. 8-94 RE: TREATMENT OF CERTAIN TAX-EXEMPT NOTES UNDER IRS RULES ____ The Institute has learned that an issue has arisen concerning the treatment under the Internal Revenue Code of tax-exempt notes originally sold at a premium and issued with a final maturity in excess of 12 months that do not pay interest at least annually. Specifically, it has come to our attention that these notes may be subject to the IRS' original issue discount rules, which makes it more likely that they will have market discount for tax purposes when sold in the secondary market. As a result, a buyer of these notes in the secondary market may have taxable ordinary income. Consequently, we have learned that there has been a decrease in their market liquidity. The IRS yesterday issued a Notice (94-84) to clarify the proper tax treatment of tax-exempt notes with original maturities of one-year or less. The Notice states that until further guidance is issued, taxpayers may treat interest that is payable at maturity either as included in the note's stated redemption price or as "qualified stated interest." Taxpayers must, however, be consistent in their treatment of such interest. The IRS Notice does not apply to notes issued with final maturities in excess of 12 months. Amy B.R. Lancellotta Associate Counsel Peter J. Cinquegrani Assistant Counsel - Tax