

MEMO# 15832

April 7, 2003

GUIDANCE ON FLOW-THROUGH OF CHARACTER OF INCOME FROM SYNTHETIC TAX-EXEMPT SECURITIES

[15832] April 7, 2003 TO: TAX MEMBERS No. 23-03 MONEY MARKET FUNDS ADVISORY COMMITTEE No. 5-03 FIXED-INCOME ADVISORY COMMITTEE No. 6-03 RE: GUIDANCE ON FLOW-THROUGH OF CHARACTER OF INCOME FROM SYNTHETIC TAX-EXEMPT SECURITIES

The Internal Revenue Service (the "Service") has issued Revenue Procedure 2003-321 pursuant to which a regulated investment company ("RIC") that is a "consenting partner" under Revenue Procedure 2002-68,2 may treat an investment in an "eligible partnership" as a direct investment in the assets of the partnership for purposes of asset diversification under Section 851(b)(3) and for purposes of eligibility to pay exempt-interest dividends under Section 852(b)(5). A RIC's interest in partnership assets will be determined, for purposes of Revenue Procedure 2003-32, in accordance with its capital interest in the partnership. As you know, Revenue Procedure 2002-68 permits a RIC to take into account each month its allocable share of tax-exempt income from certain synthetic variable rate tax-exempt securities provided that the RIC is a "consenting partner" in an "eligible partnership." 3 In Revenue Procedure 2002-68, the Service also clarified its position that such partnerships "do not meet the requirement of 1.761-2(a)(1)" and accordingly are subject to the provisions of subchapter K. Imposing subchapter K on these instruments potentially created, inter alia, an ambiguity resolved by Revenue Procedure 2003-32 regarding whether RICs could look through their partnership interests to the tax-exempt securities held by the partnership for purposes of both asset diversification under Section 851(b)(3) and flow-through of tax-exempt income to shareholders under Section 852(b)(5).

1 Revenue Procedure 2003-32 is available at <http://www.irs.gov/pub/irs-drop/rp-03-32.pdf> and is also attached to the electronic version of this memorandum. 2 See, Institute Memorandum to Tax Members No. 43-02, dated October 8, 2002, and Institute Memoranda to Money Market Funds Advisory Committee No. 5-02 and Fixed Income Funds Advisory Committee No. 11-02, dated October 9, 2002. 3 Id. In order for a partnership to be an "eligible partnership," inter alia, at least 95 percent of the partnership's income must be tax-exempt under Section 103. See, Institute Memorandum to Tax Members No. 8-02, dated February 22, 2002. 2 Effective Date While the new Revenue Procedure is effective for asset determinations made on or after March 31, 2003, the Service has provided a transition rule for asset determinations made for taxable years beginning before January 1, 2004. Under the transition rule, the Service will not challenge a RIC's tax treatment for purposes of an asset determination during the transition period provided that: (1) the partnership would be an eligible partnership under Revenue Procedure 2002-68, (2) the RICs' inclusion of income gain, loss, deduction and credits is consistent with Revenue Procedure 2002-68, and (3) the RIC's tax treatment is consistent with an election under section 761(a) to be excluded from

the provisions of subchapter K. Catherine Barré Assistant Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 15832, or call the ICI Library at (202) 326-8304 and request the attachment for memo 15832. Attachment (in .pdf format)

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