

MEMO# 3779

May 15, 1992

TREASURY DEPARTMENT ISSUES FINAL REGULATIONS ON THE INVESTMENT OF TAX-EXEMPT MUNICIPAL BOND PROCEEDS

May 15, 1992 TO: TAX MEMBERS NO. 32-92 INSTITUTIONAL FUNDS COMMITTEE NO. 7-92 MONEY MARKET MEMBERS - ONE PER COMPLEX NO. 5-92 RE: TREASURY DEPARTMENT ISSUES FINAL REGULATIONS ON THE INVESTMENT OF TAX-EXEMPT MUNICIPAL BOND PROCEEDS _____ The Treasury Department has issued final regulations (the relevant portions of which are attached) relating to the ability of tax-exempt bond issuers to invest bond proceeds in investments yielding more than the issuer is paying in interest on the tax-exempt bond. The regulations will expire on June 30, 1993. Under the previously proposed regulations, issuers investing bond proceeds in a commingled pool, including a regulated investment company ("RIC"), would have been required to gross up their income from the RIC to the extent of any fees paid by the RIC in excess of (1) 25 basis points on the first \$10 million of bond proceeds invested in the fund and (2) 12.5 basis points on any proceeds invested in the fund over \$10 million. (See Institute Memorandum to Tax Committee No. 14-92 and Institutional Funds Committee No. 5-92, dated April 6, 1992.) The proposed regulations also contained other restrictions and provisions generally applicable to commingled pools. The Institute filed a comment letter with the Treasury asserting that the proposed regulations were flawed in that: (1) mutual fund expenses are properly deducted from a fund's income before distribution, so that those expenses should not be attributed to shareholders and (2) no policy rationale exists which would justify extending the various commingled fund rules to mutual funds. The final regulations adopt the Institute's suggestion that open-end RICs (i.e., mutual funds) are not commingled funds for purposes of the regulations and thus are not subject to the fee caps imposed under the commingled fund provisions. In addition, the final regulations provide that reasonable administrative costs of a publicly offered RIC, as defined in Internal Revenue Code section 67(c)(2)(B), do not gross up the income of the RIC attributable to bond proceeds. However, a RIC will not be considered a publicly offered RIC if it is marketed or structured - 1 - for a principal purpose of attracting investors of proceeds of issues of tax-exempt bonds. The regulations do not indicate what would constitute marketing or structuring a RIC for a principal purpose of attracting bond proceeds. If a RIC does not qualify as a publicly offered RIC, it can obtain the same treatment as a publicly offered RIC if monies invested in the RIC from sources other than gross proceeds of tax-exempt bonds equal or exceed the lesser of \$50 million or 50 percent of total average daily balance of funds invested in the RIC for the current fiscal year. If a RIC fails to meet this second standard, reasonable administrative costs will be limited to 25 basis points, and any

administrative costs over that amount would gross up the income of the RIC attributable to bond proceeds. Providing the calculation of arbitrage rebate is a per se unreasonable administrative cost. We will keep you informed of further developments. David J. Mangefrida Jr. Assistant Counsel - Tax Attachment

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