

MEMO# 9787

March 20, 1998

SUPPLEMENTAL SUBMISSION ON COMPENSATING BALANCE ARRANGEMENTS

1 See Institute Memorandum to Tax Committee No. 15-97, dated April 23, 1997. [9787]
March 20, 1998 TO: TAX COMMITTEE No. 13-98 RE: SUPPLEMENTAL SUBMISSION ON
COMPENSATING BALANCE ARRANGEMENTS

As you know, the Institute last year submitted to IRS a memorandum regarding the issue, raised by IRS auditors pursuant to the “information gathering project,” of whether tax-exempt funds have taxable income equal to the amount by which a fund custody fee is reduced pursuant to a “compensating balance” arrangement.¹ Earlier this month, the Institute met with IRS representatives to discuss our 1997 memorandum and identify issues to be covered in a follow-up submission. The attached memorandum, filed today with IRS, discusses the three major issues raised at our recent meeting. (1) The “preemption issue” is whether section 61 “gross income” principles can be applied to an arrangement that constitutes a below-market loan within the meaning of section 7872. The memorandum contends that section 7872 preempts section 61 in all cases where section 7872 is applicable. (2) The “below-market loan issue” is whether the mutual fund custodial arrangements, which provide for no payment of interest, are “below-market loans” that bring the transactions within section 7872 (and hence exempt from section 61). The memorandum contends that the arguments advanced by IRS for avoiding the application of section 7872 cannot stand. (3) The “bank account exemption issue” is whether these custodial arrangements, which may be taxed only under section 7872, fall within the regulatory exemption from taxable income provided to bank accounts. The memorandum contends that there is no basis for the suggestion raised in the meeting that this exemption may not apply. Thus, the memorandum concludes, no taxable income may be imputed to the funds from these arrangements. Keith D. Lawson Senior Counsel Attachment