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IRS PRIVATE LETTER RULING ON MULTIPLE CLASS 12B-1 ARRANGEMENTS

- 1 - April 12, 1990 TO: TAX MEMBERS NO. 15-90 ACCOUNTING/TREASURERS MEMBERS NO. 11-90 RE: IRS PRIVATE LETTER RULING ON MULTIPLE CLASS 12b-1 ARRANGEMENTS _____ The attached IRS private letter ruling involves a regulated investment company ("RIC") that will charge different 12b-1 expenses to its "Class A" and "Class B" shareholders and, consequently, will pay different dividend distributions to each "class." Two issues are presented. First, will these "Class A" and "Class B" shares be treated as one or two classes for purposes of the preferential dividend rules of Code section 562(c)? Second, if the "Class A" and "Class B" shares are treated as being part of a single class, will the payment of different dividend distributions to the "Class A" and "Class B" shares cause the dividends paid to be treated as "preferential" and therefore not eligible for the dividends paid deduction? The ruling concludes that, although the two "classes" of shareholders will be treated as one class for purposes of section 562(c), the payment of different distributions with respect to the "Class A" and "Class B" shareholders will not cause the distributions to be treated as preferential dividends. The RICs involved in the ruling will each have two "classes" of shareholders. Each class will be sold without a sales charge but subject to a 12b-1 fee. "Class A" shares will pay a 12b-1 fee capped at x percent of the class' average net asset value. "Class B" shares will pay a 12b-1 fee with a higher cap (of x percent plus y percent) and the distributor will be authorized to use the y portion of the 12b-1 fee to compensate institutional shareholders for providing certain distribution- related administrative services to accounts on whose behalf the shareholders have purchased shares. A "class" of shares is described in the ruling as "a group of shareholders whose rights are so closely aligned and so different from other shareholders' rights as to warrant a conclusion that members of the group should all be treated the - 2 - same...." Applying this standard to the "Class A" and "Class B" shares involved, the ruling concludes that only one class exists because the different cash distributions to the separate "classes" and the right of "Class B" shares to effectively vote on both the "Class A" and the "Class B" 12b-1 plans are insufficient differences. The ruling then provides the following rationale for not treating the different distributions to the "Class A" and "Class B" shareholders as preferential dividends. The ruling first states that, while a 12b-1 fee is a portfolio expense for purposes of computing investment company taxable income, 12b-1 fees "are akin to front-end sales loads because both amounts are primarily for distribution expenses." Treating these expenses as "indirect" shareholder expenses, the ruling concludes that all shareholders have the benefit of the same economic distributions because all shareholders are entitled to the same distribution before 12b-1 fees are taken into account. As each shareholder has the benefit of the same economic distribution, no preferential dividend arises. The ruling further

concludes that treating 12b-1 fees as indirect investor expenses for purposes of section 562(c) does not cause a shareholder to treat his allocable share of the 12b-1 fee as income for income recognition purposes because of the exemption provided in Code section 67(c) for publicly offered RICs. We will keep you informed of developments. Keith D. Lawson Assistant General Counsel Attachment

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