

**MEMO# 8568**

January 20, 1997

## **FEBRUARY 4 MEETING ON THE USE OF ""COMPENSATING BALANCE"" ARRANGEMENTS BY TAX-EXEMPT FUNDS**

1 In support of its position, the IRS has cited the following authorities: Revenue Ruling 79-247, 1979-2 C.B. 24 ("credits" earned on money deposited with a stockbroker, which can be used only to offset commissions payable to the broker, are income to the investor); *Murphy v. Commissioner*, 92 T.C. 12 (1989) (individual taxpayer may not offset interest income with interest expenses); *Island Creek Coal Company v. Commissioner*, 30 T.C. 370 (1958) (mine operating expenses may not be offset by nonmining income for purposes of calculating percentage depletion); Revenue Ruling 82-59, 1982-1 C.B. 47 (individual taxpayer may not offset checking account interest income with check-writing fees); *Lucas v. Earl*, 281 U.S. 111 (1930) (assignment of income); and *Helvering v. Horst*, 311 U.S. 112 (1940) (assignment of income). 2 See Institute Memorandum to Accounting/Treasurers Members No. 24-96 and Tax Members No. 42-96, dated September 6, 1996. January 20, 1997 VIA FAX TO: TAX COMMITTEE No. 3-97 RE: FEBRUARY 4 MEETING ON THE USE OF ""COMPENSATING BALANCE"" ARRANGEMENTS BY TAX-EXEMPT FUNDS

The Institute has learned that in audits of tax-exempt funds the IRS intends to examine the treatment of any "compensating balance" or "expense offset" arrangements with custodians because the IRS believes that such arrangements may generate taxable income to the fund. We understand that in these types of arrangements the fund's cash balance with the custodian is taken into account explicitly in determining the custodian's fee. The IRS has asserted that the amount by which the gross custody fee is reduced should be treated by the fund as taxable income.<sup>1</sup> We understand that at this time the IRS is not asserting that a fund has taxable income as a result of an arrangement with a custodian in which the fund's cash balance with the custodian is taken into account implicitly in determining the custodian's fee. Since the IRS has requested the Institute's views on this matter, the Institute has scheduled a meeting to discuss industry practices in this area for Tuesday, February 4, at 10:00 a.m. in the David Silver Conference Room, located on the 12th floor of our offices at 1401 H Street, N.W. Lunch will be served following the meeting. Members planning to attend the February 4 meeting should fax the attached response form to Ana Alvarez at (202) 326-5839 no later than January 30, 1997. According to an IRS representative, the IRS has started approximately 25 audits pursuant to its initiative to audit the returns of investment companies. As we previously informed you,<sup>2</sup> we understand that the IRS intends to audit approximately 40 to 50 funds pursuant to the initiative. We will keep you informed of developments. Anne M. Barr Associate Counsel - Tax Attachment

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