MEMO# 8828

April 23, 1997

INSTITUTE SUBMISSION ON COMPENSATING BALANCE ARRANGEMENTS

1 See Institute Memoranda to Tax Committee No. 3-97, dated January 20, 1997, and No. 13-97, dated April 11, 1997. April 23, 1997 TO: TAX COMMITTEE No. 15-97 RE: INSTITUTE SUBMISSION ON COMPENSATING BALANCE ARRANGEMENTS ____ As you know, Internal Revenue Service ("IRS") auditors have suggested that tax-exempt funds may have taxable income equal to the amount by which a fund custody fee is reduced pursuant to a "compensating balance" arrangement.1 Because of the industry-wide interest in this issue, the Institute filed today with IRS the attached memorandum, which sets forth the industry's response to the IRS tentative position on custody fee reduction arrangements. The memorandum notes that the compensating balance arrangements entered into with respect to fund custody accounts with the banks constitute "below market" loans for purposes of Code section 7872. However, Temp. Treas. Reg. section 1.7872-5T(b)(2) exempts from the application of section 7872 "bank deposits," such as the deposit accounts maintained by funds with their custodian banks. Thus, no taxable income arises to the funds under section 7872. Moreover, because Congress intended section 7872 to be the exclusive basis for taxing all below market loans, the Service cannot apply section 61 "gross income" principles to these arrangements. Finally, if the Service determines that these custodial arrangements have a significant tax effect, the Service has the regulatory authority to address this issue, but only on a prospective basis. We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment (in .pdf format)