

**MEMO# 18829**

May 4, 2005

## **UPDATED GUIDANCE ON FLOW-THROUGH CHARACTER OF INCOME FROM SYNTHETIC TAX-EXEMPT SECURITIES**

©2005 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [18829] May 4, 2005 TO: TAX MEMBERS No. 12-05 MONEY MARKET FUNDS ADVISORY COMMITTEE No. 8-05 FIXED-INCOME ADVISORY COMMITTEE No. 10-05 RE: UPDATED GUIDANCE ON FLOW-THROUGH CHARACTER OF INCOME FROM SYNTHETIC TAX-EXEMPT SECURITIES The Internal Revenue Service (the "Service") has issued Revenue Procedure 2005-20, which describes conditions under which a regulated investment company ("RIC") that holds a partnership interest in a synthetic tax-exempt variable rate bond ("Synthetic Tax-Exempt Security") is treated as if it directly invested in the assets held by the partnership for purposes of the RIC qualification requirements of Code section 851(b)(3) and the tax-exempt dividend eligibility rule of Code section 852(b)(5). Rev. Proc. 2005-20 amplifies and supersedes related guidance provided on this issue in 2002 and 2003. Under guidance issued in 2002, muni bond fund partners take into account each month their allocable share of tax-exempt income from certain Synthetic Tax-Exempt Securities.<sup>1</sup> Guidance issued in 2003<sup>2</sup> allows eligible RICs to look through their partnership interests to the tax-exempt securities held by the partnership for purposes of both asset diversification and flow-through of tax-exempt income to shareholders. Additional guidance also issued in 2003<sup>3</sup> superseded the 2002 guidance by, among other things, clarifying and broadening the universe of partners and partnerships eligible to receive look-through treatment. Rev. Proc. 2005-20 consolidates prior guidance in two ways. First, Rev. Proc. 2005-20 extends the look-through treatment provided in Rev. Proc. 2003-32 to the expanded universe of partners and partnerships described in Rev. Proc. 2003-84 or in any successor published 1 See, e.g., Rev. Proc. 2002-68. See Institute Memorandum (15245) to Tax Committee No. 30-02, Money Market Funds Advisory Committee No. 5-02 and Fixed-Income Advisory Committee No 11-02, dated October 9, 2002. 2 See, e.g., Rev. Proc. 2003-32. See Institute Memorandum (15382) to Tax Committee No. 23-03, Money Market Funds Advisory Committee No. 5-03 and Fixed-Income Advisory Committee No 6-03, dated April 7, 2003. 3 See, e.g., Rev. Proc. 2003-84. See Institute Memorandum (16745) to Tax Committee No. 60-03, Money Market Funds Advisory Committee No. 18-03 and Fixed-Income Advisory Committee No 16-03, dated November 6, 2003. 2 guidance that provides substantially the same treatment for consenting partners in eligible tax- exempt bond partnerships. Second, Rev. Proc. 2005-20 extends the effective date transition relief for look-through treatment provided by Rev. Proc. 2003-32 to the expanded universe of partners and partnerships eligible to receive look-through treatment, as provided for by a grandfather rule in Rev. Proc. 2003-84. Lisa Robinson Associate

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