

**Internal Revenue Service**

**Department of the Treasury**

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Legend

Tax-Free Funds =

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.Advisor =

Distributor =

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Dear

This responds to your request dated November 3, 1999, on behalf of the Tax-Free Funds, that the Internal Revenue Service rule on the status of certain exempt-interest dividends in the hands of a Tax-Free Fund.

## FACTS

Each Tax-Free Fund is organized under state law either as a corporation or as a business trust that issues a single series of shares or as one series of a multi-series trust. Each series of a corporation or business trust and each trust is registered as an open-end management investment company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.*, as amended (the 1940 Act). Each Tax-Free Fund has elected to qualify as a regulated investment company (RIC) under section 851 of the Internal Revenue Code.

Advisor is the investment advisor for the Tax-Free Funds. Advisor is also the investment advisor for three tax-exempt money market funds (the "Tax-Exempt Money Funds") in which the Tax-Free Funds seek to invest, as further described herein.

Distributor is the distributor for the Tax-Free Funds. Distributor is an affiliate of Advisor.

Each Tax-Free Fund seeks to invest cash in one or more of the Tax-Exempt Money Funds, affiliated RICs that qualify to pay exempt-interest dividends under section 852(b)(5) of the Internal Revenue Code. This cash is generated from a number of sources, including interest received on portfolio securities, unsettled securities transactions, reserves held for investment strategy purposes, scheduled maturity of investments, liquidation of investment securities to meet anticipated redemptions, new monies received from investors, and market conditions warranting a cash-oriented defensive position. Each Tax-Free Fund represents that no more than 50% of its assets will be invested in one or more of the Tax-Exempt Money Funds.

By consolidating their cash management needs, the Tax-Free Funds may achieve various benefits. These include freedom from investment minimums, efficiencies and economies of scale, an enhanced investment return, and better liquidity and portfolio diversification and duration. The Tax-Exempt Money Funds can be expected to benefit in a similar fashion from the increase in assets associated with this investment of cash.

The Tax-Free Funds have obtained an order for exemptive relief from the Securities and Exchange Commission (SEC) permitting them to use uninvested cash and cash collateral to purchase shares in the Tax-Exempt Money Funds. Under the terms of the SEC order, a Tax-Free Fund's investment in its affiliate(s) is permissible only to the extent that its aggregate investment in all the Tax-Exempt Money Funds does not exceed x% of the Tax-Free Fund's total assets.

Each Tax-Free Fund and each Tax-Exempt Money Fund represents that, at the close of each quarter of its taxable year, at least 50% of the value (as defined in section 851(c)(4)) of its assets consists of obligations described in section 103(a). Each Tax-

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Free Fund and each Tax-Exempt Money Fund further represents that it complies with the requirements of section 852(b)(5)(A), pertaining to the mailing of written notices designating distributions as exempt-interest dividends.

#### LAW AND ANALYSIS

Section 852(b)(5) of the Code provides that a RIC shall be qualified to pay exempt-interest dividends if, at the close of each quarter of its taxable year, at least 50 percent of the value of its total assets consists of obligations described in section 103(a). Section 852(b)(5)(A) defines the term "exempt-interest dividend" as any dividend or part thereof paid by a RIC and designated by it as an exempt-interest dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including exempt-interest dividends paid after the close of the taxable year as described in section 855) is greater than the excess of--

- (i) the amount of interest excludable from gross income under section 103(a), over
  - (ii) the amounts disallowed as deductions under sections 265 and 171(a)(2),
- the portion of such distribution which shall constitute an exempt-interest dividend shall be only that proportion of the amount so designated as the amount of such excess for such taxable year bears to the amount so designated.

Section 852(b)(5)(B) provides that an exempt-interest dividend shall be treated by the shareholders for all purposes of the subtitle (Subtitle A, Income Taxes) as an item of interest excludable from gross income under section 103(a). Such purposes include but are not limited to--

- (i) the determination of gross income and taxable income,
- (ii) the determination of distributable net income under subchapter J,
- (iii) the allowance of, or calculation of the amount of, any credit or deduction, and
- (iv) the determination of the basis in the hands of any shareholder of any share of stock of the company.

The treatment of the exempt-interest dividends paid by a Tax-Free Money Fund in the hands of its shareholders is governed by section 852(b)(5)(B) for all purposes of Subtitle A. One of the purposes of Subtitle A specifically enumerated in section 852(b)(5)(B)(i) is the determination of taxable income. Whether an item of income is an item of interest excludable from gross income under section 103(a) for purposes of section 852(b)(5)(A)(i) is such a determination. Accordingly, each Tax-Free Fund shall treat the exempt-interest dividends received from a Tax-Exempt Money Fund, or from any other RIC qualifying to pay exempt-interest dividends in accordance with section 852(b)(5), as an item of interest excludable from gross income under section 103(a) for all purposes of Subtitle A, including section 852(b)(5)(A)(i).

## CONCLUSION

Based on the facts and representations set forth above, we rule that exempt-interest dividends that are paid to a Tax-Free Fund are treated under section 852(b)(5)(B) as an item of interest excludable under section 103(a) in the hands of a Tax-Free Fund for purposes of section 852(b)(5)(A)(i).

No opinion is expressed, however, as to whether the Tax-Free Funds or the Tax-Exempt Money Funds qualify as RICs that are taxable under subchapter M, part I of the Code or whether they qualify to pay exempt-interest dividends under the requirements of section 852(b)(5).

Except as specifically ruled upon above, we express no opinion on the federal tax consequences of the described transaction under any other provisions of the Code.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,  
Assistant Chief Counsel  
(Financial Institutions & Products)

By: William E. Coppersmith  
Chief, Branch 2