Internal Revenue Service

U.I.L. Nos: 0561.05-00, 0562.03-02
0851.00-00, 0852.01-00

Department of the Treasury

1111 Constitution Avenue, NW
Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:FI&P:1/PLR-103949-99
Date: September 3, 1999

LEGEND

Underlying Funds =

Trust a =
Trust b =
Trust c =
Advisor m =
Advisor n =
Advisor p =

Dear:

This is in reply to your letter dated February 11, 1999, and subsequent correspondence, submitted on behalf of the Underlying Funds. You requested a ruling on whether payment of certain expenses of the Upper-Tier Funds by the Underlying Funds and the investment advisor of the Upper-Tier Funds (Advisor m) is a preferential dividend within the meaning of § 562(c) of the Internal Revenue Code.

FACTS

Trust a, Trust b, and Trust c are open-end management investment companies organized as Massachusetts business trusts. Each Trust is registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the 1940 Act).

The Underlying Funds are separate series of either Trust b or Trust c. Each Underlying Fund is treated as a separate corporation for federal income tax purposes pursuant to § 851(g) and intends to qualify annually as a regulated investment company (RIC) under subchapter M of the Code.

The Upper-Tier Funds are separate series of Trust a. Each Upper-Tier Fund is treated as a separate corporation for federal income tax purposes pursuant to § 851(g), and intends to elect

and qualify annually to be treated as a RIC under subchapter M of the Code.

Advisor n and Advisor p provide investment advice to the Underlying Funds in exchange for a fee computed as a certain percentage of an Underlying Fund's average daily net asset value.

Some of the Underlying Funds are self-distributed and, therefore, do not engage an outside distributor. A number of the Underlying Funds offer multiple classes of shares pursuant to a multiple class distribution arrangement. The Underlying Funds are "no load" mutual funds and, therefore, generally are not marketed to customers through retail brokers.

To provide retail broker-advised mutual fund investors access to the Underlying Funds, the Upper-Tier Funds have been created. Each Upper-Tier Fund intends to invest substantially all of its assets in the shares of one corresponding Underlying Fund. As long an Upper-Tier Fund invests in only one Underlying Fund, the investment adviser to the Upper-Tier Funds (Advisor m) will not charge an advisory fee.

The taxpayers propose the following expense arrangements: (a) a special servicing agreement among Trust a on behalf of the Upper-Tier Funds, the Upper-Tier funds' transfer agent, and each Underlying Fund (Special Servicing Agreement); (b) an administration agreement between Advisor m and Trust a on behalf of the Upper-Tier Funds (Administrative Agreement); and (c) a fee paid by Advisor n and Advisor p to Advisor m for certain costs borne by Advisor m.

The Special Servicing Agreement provides for transfer agency services for the Upper-Tier Funds. Under the Special Servicing Agreement, each Underlying Fund will pay the shareholder servicing costs of its corresponding Upper-Tier Fund. In no event, however, will this amount exceed the estimated savings in shareholder servicing costs an Underlying Fund enjoys by virtue of the operation of the corresponding Upper-Tier Fund. Having an Upper-Tier Fund as a shareholder is expected to reduce expenses to the Underlying Fund relative to the expenses it would incur if the Upper-Tier Fund's shareholders were to invest directly in the Underlying Fund. The Upper-Tier Funds will reduce the shareholder servicing costs to the Underlying Funds by consolidating separate shareholder accounts. Additionally, to the extent an Upper-Tier Fund attracts additional assets to the Underlying Fund, the expense ratio of the Underlying Fund is expected to decrease.

The Administration Agreement provides for all other services necessary for the operation of the Upper-Tier Funds, including office space, office supplies, facilities, equipment, managing personnel, accounting, custody, auditing, legal, and shareholder

services. Under the Administration Agreement, the Upper-Tier Funds will pay Advisor m a fixed fee based on the percentage of net assets invested in the Upper-Tier Funds. In return for this fee, Advisor m will provide various administrative services to the Upper-Tier Funds and directly pay the Upper-Tier Funds' expenses, except those expenses paid by the Underlying Funds under the Special Servicing Agreements.

Having an Upper-Tier Fund as a shareholder is expected to increase the advisory fee an Underlying Fund pays its investment advisor (Advisor n or Advisor p, as the case may be). In consideration for this additional income derived from the operation of the Upper-Tier Funds, Advisor n and Advisor p will pay to Advisor m a fee based on a percentage of the net asset value of the shares of each Underlying Fund held by a corresponding Upper-Tier Fund.[1] This fee arrangement is not part of the Shareholder Servicing Agreement or the Administrative Agreement. Advisor n and Advisor p expect increased advisory fees from having an Upper-Tier Fund as a shareholder of the corresponding Underlying Fund even after taking into account the fee paid to Advisor m.

The Underlying Funds that offer multiple classes of shares represent that each fund meets the requirements set out in section 3 of Rev. Proc. 96-47, 1996-2 C.B. 338. The rights and obligations of the shareholders of each Qualified Group (as that term is defined in the Revenue Procedure) are set forth in the funds' organizing documents, which include any written plans required under Rule 18f-3 (17 C.F.R. § 270.18f-3 promulgated under the 1940 Act).

In addition, each Underlying Fund makes the following representations:

> The Underlying Fund's investment advisor may waive or reimburse all or a part of the management fee charged to the Underlying Fund, provided that any waiver or reimbursement of the fee will be applied to all shares of the Underlying Fund in proportion to their relative net asset values.
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> The entity that charges a fee for an expense allocated to a group of shares on the basis of the amount incurred may waive or reimburse that fee in

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[1] Initially, Advisor p's Underlying Funds may not enter into the Special Servicing Agreement. Until they do so, Advisor m will pay the shareholder servicing costs that would have been paid by the Underlying Funds under the Special Servicing Agreement. To reimburse Advisor m for these costs, Advisor p will increase the fee it pays Advisor m.

whole or in part only if the revised fee more accurately reflects the relative costs of providing to each group of shares the service for which the expense was charged.

The distributor or other service provider under a Rule 12b-1 plan or shareholder service plan may waive or reimburse in whole or in part its fee charged to any group of shares under a Rule 12b-1 plan or shareholder services plan.

LAW

Section 851(a) defines a RIC, in part, as a domestic corporation registered under the 1940 Act as a management company.

Section 851(b) limits the definition of a RIC to a corporation meeting certain election, gross income, and diversification requirements.

Section 851(g) provides a special rule for a RIC having more than one fund. This provision treats each fund as a separate corporation for all purposes of the Code, other than the definitional requirement of § 851(a).

A corporation that is a RIC within the meaning of § 851 and that is taxable under subchapter M, part I, pays tax on its investment company taxable income under § 852(b)(2) and on the excess, if any, of its net capital gain over its deduction for dividends paid, determined with reference to capital gain dividends only under § 852(b)(3).

Section 852(a) provides that a RIC is not taxable under subchapter M, part I, unless its deduction for dividends paid (as that term is defined in § 561(a) with certain modifications) for the taxable year equals or exceeds a specified portion of its taxable income (with certain adjustments) and its net tax-exempt interest income.

Section 561(a) defines the deduction for dividends paid, for purposes of § 852, to include dividends paid during the taxable year.

Section 561(b) applies the rules of § 562 to determine which dividends are eligible for the deduction for dividends paid under § 561(a).

Section 562(a) states that the term "dividend", except as otherwise provided, includes only dividends described in § 316 (which provides a definition of dividends for purposes of corporate distributions).

Section 316(a) defines the term "dividend" as any distribution of property made by a corporation to its shareholders (1) out of its earnings and profits (E & P) accumulated after February 28, 1913, or (2) out of its E & P of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the E & P at the time the distribution was made.

Section 562(c) provides that the amount of any distribution shall not be considered as a dividend for purposes of computing the dividends paid deduction under § 561 unless the distribution is pro rata, does not prefer any shares of stock of a class over other shares of stock of that same class, and does not prefer one class of stock over another class except to the extent that one class is entitled (without reference to waivers of their rights by shareholders) to be preferred.

CONCLUSION

Because of the unique nature of open-end RICs, payments of the operating expenses of the Upper-Tier Funds by the Underlying Funds and Advisor m pursuant to the Special Servicing Agreements and Administrative Agreements are not preferential dividends within the meaning of § 562(c).

Except as specifically ruled upon above, no opinion is expressed or implied regarding the federal tax aspects of this transaction.

This ruling is directed only to the Underlying Funds. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax return of an Underlying Fund for each taxable year in which the Underlying Fund pays the operating expenses under the above described Special Servicing Agreement.

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

By: _____
Jonathan Zelnik
Assistant to the Chief, Branch 1

Enclosure:

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