

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact:  
, ID No.

Telephone Number:

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Date:  
September 13, 2006

Legend:

Taxpayers =

Company =  
Adviser =  
State A =  
State B =  
Date 1 =  
Date 2 =

Dear :

This responds to your request dated July 18, 2005, submitted on behalf of Taxpayers, that the Internal Revenue Service rule that (1) neither the deposit of a certain amount in a special bank account nor payments thereof to be made to certain of their former and current shareholders, all as described below, will be includible in their gross income and (2) the distribution of those payments to those shareholders (a) will not result in them being treated as having paid preferential dividends within the meaning of section 562(c) of the Internal Revenue Code (Code) and (b) will not adversely affect their qualification as a regulated investment company under Part I of Subchapter M of Chapter 1 of the Code ("RIC").

## FACTS

Company is a corporation that has Articles of Incorporation on file with State A, and is currently registered, and at all times during the Taxpayers' most recently completed taxable year was registered, as a diversified, open-end management company under the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 to 80b-2) (the 1940 Act). As a management company registered under the 1940 Act, Company qualifies as a RIC within the meaning of section 851 of the Code and has been taxable under subchapter M, part I, of the Code.

Each of the Taxpayers is a segregated portfolio of assets of the Company, and is engaged in the business of an investment company, that is, as a "mutual fund." As such, each of the Taxpayers is a "fund" as defined in section 851(g)(2) and, accordingly, is treated as a separate corporation for federal tax purposes pursuant to section 851(g)(1) (except with respect to the definitional requirements of section 851(a), which the Company satisfies). Each of the Taxpayers' taxable year ends on Date 1 each year. The Taxpayers use the accrual method of accounting for maintaining their accounting books and filing their federal income tax returns.

Adviser, a State B corporation, is registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940, as amended (the Advisers Act), as an investment adviser. Adviser provides investment advisory services to Company, which operates the Taxpayers.

The Securities and Exchange Commission (SEC) issued an order dated Date 2 (the Order), stating that Adviser charged the Taxpayers an illegal performance-based fee in violation of section 205 of the Advisers Act, and as a result, the Taxpayers and, consequently, their respective shareholders were overcharged (the Overcharges). The Order required the creation of a distribution plan (the distribution plan) for the distribution of the aggregate Overcharges (the Disgorgement) plus prejudgment interest (the Interest) to the current or former shareholders of the Taxpayers who were overcharged as a result of the illegal fee. The distribution plan requires that the Disgorgement and Interest be paid directly by the Adviser to the shareholders who were harmed by the Overcharges rather than to the Taxpayers themselves.

## LAW & ANALYSIS

Section 61(a) of the Code states that except as otherwise provided in Subtitle A (Income Taxes), gross income means all income from whatever source derived, including but not limited to certain items listed therein.

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(b)(2) provides that a corporation is not a RIC for any taxable year unless at least 90 percent of its gross income is derived from certain enumerated sources, including other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to the RIC's business of investing in stock, securities, or currencies.

A corporation that is a RIC within the meaning of section 851 and that is taxable under subchapter M, part I, pays tax on its investment company taxable income under section 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 under section 852(b)(3).

Section 852 provides that a RIC is not taxable under subchapter M, part I, unless its deduction for dividends paid (as that term is defined in section 561(a) with certain modifications) for the tax 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 section 852, to include dividends paid during the tax year. Section 561(b) applies the rules of section 562 to determine which dividends are eligible for the deduction for dividends paid under section 561(a).

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 section 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

Based on the specific facts presented in this case, the Disgorgement and Interest are being paid by the Advisor directly to the shareholders who were harmed by the overcharges pursuant to the SEC order. In form, the Taxpayers are bypassed and do not actually receive the reimbursement. Because there is no receipt, there is no income to the Taxpayers for purposes of section 851(b)(2).

Similarly, because in form the Advisor rather than the Taxpayers are distributing the reimbursement to the shareholders who were harmed, the Taxpayers are not paying a preferential dividend to the shareholders.

Because there is no income to the Taxpayers, nor a preferential dividend being paid by the Taxpayers, there is no impact on their qualifications as RICs. Further, if the Taxpayers are deemed to have constructively received the reimbursement from the Advisor and then subsequently distributed it to its current shareholders, it would not adversely impact the Taxpayers' qualifications as RICs.

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

A copy of this letter should be attached to the federal income tax returns of the Taxpayers for each taxable year in which the Adviser pays compensation to a shareholder under the circumstances described above.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Christopher F. Kane  
Branch Chief, Branch 3  
(Income Tax & Accounting)

cc: