

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 103, 702, 706, 707, 851, 852; 1.706-1.)

Rev. Proc. 2002-16

SECTION 1. PURPOSE

This revenue procedure allows certain partnerships that invest in assets exempt from taxation under § 103 of the Internal Revenue Code to make an election that enables money market fund partners to take into account monthly the inclusions required under §§ 702 and 707(c).

SECTION 2. BACKGROUND

Certain money market funds seek investments with a yield that reflects current short-term exempt interest rates and that is treated for federal income tax purposes as being composed of interest exempt from tax under § 103. For purposes of this revenue procedure, a money market fund is a fund described in the Securities and Exchange Commission's Rule 2a-7 (Rule 2a-7), 17 CFR 270.2a-7, issued under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. One investment that offers these advantages is an instrument that might be described as a synthetic tax-exempt variable-rate bond. To create such an instrument, a sponsor or an affiliate (the Sponsor) purchases (either at original issue or on the secondary market) an obligation the interest income on which is excluded under § 103 (§ 103 obligation) and transfers

the § 103 obligation to an entity that qualifies as a partnership for federal tax purposes (tax-exempt bond partnership). The tax-exempt bond partnership issues two classes of equity interests: a preferred interest that is entitled to a variable return on its capital contribution (preferred interest), and a second class of ownership interest that is entitled to all of the remaining income of the partnership (residual interest). The variable return on the preferred interest tracks current short-term exempt yields.

Under § 702(b), if a partnership receives income that is exempt from tax under § 103, the income retains its character when the partnership allocates it to a partner. Under § 706(a), a partner includes in taxable income for a taxable year the partner's allocable share of items of partnership income, gain, loss, deduction, and credit for the partnership's taxable year ending within or with the partner's taxable year.

Section 852(a) provides generally that a regulated investment company (RIC), including a RIC that is a money market fund, must distribute each taxable year at least 90 percent of its net interest income that is excludible from gross income under § 103(a). Section 852(b)(5) provides that if, at the close of each quarter of the RIC's taxable year, at least 50 percent of the value (as defined in § 851(c)(4)) of the total assets of the RIC consists of obligations described in § 103(a), the RIC is qualified to pay exempt-interest dividends (as defined in § 852(b)(5)(A)) to its shareholders. Under § 852(b)(5)(A), an exempt-interest dividend means any dividend or part thereof paid by a RIC and designated by the RIC as an exempt-interest dividend in a written notice mailed to its shareholders not later than 60 days after the close of the RIC's taxable year.

To maintain a constant net asset value for each share of stock, as is described in Rule 2a-7, money market funds commonly declare dividends daily and pay dividends monthly. (In this paragraph and the next, the word “dividend” refers to a distribution that is treated as a dividend for purposes of state corporate law and federal securities law, whether or not the distribution is also treated as a dividend for purposes of the Code.) In the case of a money market fund that intends to pay exempt interest dividends, substantially all of the fund’s income typically will be exempt from tax under § 103. If, however, such a money market fund has a taxable year that differs from that of a tax-exempt bond partnership in which it holds an interest, there may be a mismatch between the money market fund’s monthly distribution of income and the money market fund’s inclusion of its distributive share of partnership income under § 706(a). As a result, the money market fund’s distribution of tax-exempt income may be treated as a return of capital. Alternatively, the money market fund may distribute less than its entire distributive share of partnership income for the taxable year.

For example, assume that on January 2, 2002, a money market fund with a taxable year ending June 30 acquires a preferred interest in a tax-exempt bond partnership with a taxable year ending December 31. Under § 706(a), the money market fund’s distributive share of the tax-exempt bond partnership’s income for the money market fund’s taxable year ending June 30, 2002, is zero. If the money market fund’s daily dividends do not reflect its portion of the interest that the partnership earns between January 2 and June 30, the fund will be unable to maintain a constant net asset value for each share of its stock. (Whether or not the tax-exempt bond partnership distributes the exempt interest to the money market fund as that interest is

earned, the per share net asset value of the fund will rise if the fund does not make continual distributions to its shareholders to reflect those partnership earnings.) On the other hand, if the money market fund's daily dividends are based in part on the income earned by the partnership between January 2, 2002, and June 30, 2002, the distributions made by the money market fund during its taxable year ending June 30, 2002, will exceed the includible tax-exempt income for the year, causing all or a portion of those distributions to be characterized as a return of capital.

The Treasury Department and the Internal Revenue Service have determined that it is in the best interest of sound tax administration to allow certain money market funds to take into account on a monthly basis their distributive shares of partnership items if the partnership makes a proper election under this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to eligible partnerships (described in section 3.01 of this revenue procedure) that elect to close their books monthly (the Monthly Closing Election) and to eligible partners (described in section 3.02 of this revenue procedure) that consent to take into account their distributive shares of partnership income on a monthly basis (the Monthly Closing Consent).

.01 Eligible Partnership.

(1) Generally. An entity is an eligible partnership if all of the following conditions are met as of the test date:

- (a) The entity is a partnership for federal tax purposes;
- (b) All allocations of income, gain, loss, deduction, and credit of the partnership have substantial economic effect; and

(c) At least 95 percent of the partnership's income for the test period was (or is reasonably expected to be) income that is exempt from tax under § 103.

(i) If, on the test date, the partnership has been in existence for at least 6 full calendar months, then the test period is the 6 full calendar months preceding the test date; and

(ii) If, on the test date, the partnership has not been in existence for at least 6 full calendar months, then the test period is the first 6 full calendar months of the partnership's existence.

(2) Test Date. The test date is the first day of the month for which the Monthly Closing Election is effective.

.02 Eligible Partner. A partner is an eligible partner if it is a RIC, as defined in § 851, that is entitled to hold itself out as a money market fund, or the equivalent of a money market fund, in accordance with the provisions of Rule 2a-7(b).

SECTION 4. MONTHLY CLOSING ELECTION AND CONSENT

.01 Effect of Election and Consent. If, at the end of any calendar month, an eligible partnership has a Monthly Closing Election in effect and one or more eligible partners of the partnership has a Monthly Closing Consent in effect, then, with respect to each such partner, the partnership must close its books as described in § 1.706-1(c)(2) of the Income Tax Regulations as if the partner had sold its entire interest in the partnership on the last day of that month. The partner must include in its taxable income for that month the partner's distributive share of items described in § 702(a) earned by the partnership since the last closing of the books with respect to

that partner and any guaranteed payments under § 707(c) to the partner that are deductible by the partnership since the last closing of the books with respect to that partner. If the partner is on a 52-53 week taxable year, then the provisions of § 1.441-2T(e) apply as if the last day of the month was the last day of the partnership's taxable year.

.02 Reporting Requirements. In connection with this monthly closing of the books, the partnership must provide each consenting eligible partner information with respect to the partner's distributive share of items described in § 702(a) and any guaranteed payments under § 707(c). To satisfy this requirement, the partnership may use a Schedule K-1 (Form 1065), Partner's Share of Income, Credits, Deductions, etc., or any other document or electronic communication that provides substantially equivalent information (monthly statements). The partnership and each consenting eligible partner must maintain the monthly statements but should not file them with the Service. At the end of its taxable year the partnership must provide a single Schedule K-1 (Form 1065) to each of its partners (both the consenting and the nonconsenting partners). In the case of a consenting eligible partner, this single annual Schedule K-1 must include all amounts shown on the monthly statements issued to the partner.

SECTION 5. MONTHLY CLOSING ELECTION

.01 Manner of Partnership Making the Election. An eligible partnership may make a Monthly Closing Election by filing a statement with the appropriate service center. The statement must be titled "ELECTION UNDER REVENUE PROCEDURE 2002-16," and must include:

- (1) Identification of the partnership by name, address, and EIN, and the name and phone number of a contact person for the partnership;
- (2) A statement that the partnership elects a monthly closing of the books for all present and future consenting eligible partners;
- (3) The signature of a person with authority to sign the partnership's Form 1065, U.S. Return of Partnership Income; and
- (4) The effective month of the election. The election is effective for the calendar month in which the election is filed, unless the partnership requests the election to be effective for either of the two immediately preceding calendar months. For example, if a calendar year partnership states that the monthly closing system is to begin for June, the partnership will close its books June 30. Consenting eligible partners must include their shares of partnership items and guaranteed payments for the period from the last closing of the books (generally December 31 of the prior year) through June 30. There will be a closing of the books and a monthly inclusion of the partner's share of these items and guaranteed payments at the end of each future month.

.02 Time for Making the Election. The partnership's Monthly Closing Election may be made at any time. See, however, section 6.03 of this revenue procedure for limitations on the time for a partner to effect a Monthly Closing Consent.

SECTION 6. MONTHLY CLOSING CONSENT

.01 Manner of Partner Effecting the Consent.

- (1) An eligible partner effects a Monthly Closing Consent by providing a statement of consent to the custodian or manager of the partnership. The statement of

consent should also be attached to the partner's Form 1120RIC, U.S. Income Tax Return for Regulated Investment Companies, for the first taxable year in which the consent is effective. Failure to attach the partner's statement of consent to the partner's Form 1120RIC does not invalidate the partner's consent, however.

(2) The statement of consent must be titled "STATEMENT OF CONSENT TO ELECTION UNDER REVENUE PROCEDURE 2002-16" and must include:

(a) Identification of both the consenting partner and the partnership by name, address, and EIN, and the name and phone number of a contact person for each;

(b) A statement that the partner consents to the partnership's election to a monthly closing of the books and that the partner will include in its taxable income its distributive share of partnership items described in § 702(a) and any guaranteed payments under § 707(c) in a manner that is consistent with the election;

(c) The signature of an officer of the partner who is authorized to act on behalf of the partner; and

(d) The effective month of the consent. The consent is effective for the calendar month in which the partner acquires the partnership interest, unless the partner requests that the consent be effective for either of the two immediately following calendar months.

.02 Additional Requirements for Making a Valid Monthly Closing Consent. An eligible partner does not qualify for the treatment described in section 4 of this revenue procedure unless:

(1) The partner provides the statement of consent described in section 6.01 of this revenue procedure to the custodian or manager of the partnership no later than the last day of the second calendar month after the calendar month in which the partner acquires the partnership interest; and

(2) The partnership's Monthly Closing Election is effective no later than the second calendar month after the calendar month in which the partner acquires the partnership interest.

SECTION 7. TERMINATION OF MONTHLY CLOSING ELECTION OR MONTHLY CLOSING CONSENT

.01 A Monthly Closing Election or Monthly Closing Consent may be revoked only with the consent of the Commissioner.

.02 Each month after the first calendar quarter in which a partnership's Monthly Closing Election is effective, the definition of eligible partnership in section 3.01 of this revenue procedure is reapplied to the partnership, using the last day of the month as the test date and that month and the preceding 2 months as the test period. If for any month the partnership fails to satisfy the test mandated by the preceding sentence, then the partnership's Monthly Closing Election is terminated as of first day of the month. Even if the partnership subsequently qualifies as an eligible partnership, it may not make another Monthly Closing Election without the Commissioner's consent.

.03 If a consenting partner's status as an eligible partner (as defined in section 3.02 of this revenue procedure) changes at any time, the partner's Monthly Closing Consent is ineffective on any day when that definition is not satisfied and is effective on any day when it is. Therefore, no new Monthly Closing Consent is required when a

consenting partner sells one interest in an electing partnership and acquires another interest in the same partnership at a time when the partnership continues to have its Monthly Closing Election in effect.

SECTION 8. TRANSITION RULES FOR SOME ELECTIONS AND CONSENTS THAT ARE REQUESTED TO BECOME EFFECTIVE DURING 2002

.01 Certain Monthly Closing Elections Filed During 2002. If, using February 1, 2002, as the test date, a partnership is an eligible partnership, or is an existing but ineligible partnership, and, at any time during 2002, the partnership files the statement described in section 5.01 of this revenue procedure, then, in addition to the permissible effective dates described in section 5.01(4) of this revenue procedure, the partnership may request that the Monthly Closing Election become effective for any month in 2002 in which the partnership is an eligible partnership.

.02 Certain Monthly Closing Consents Provided to an Eligible Partnership During 2002. In the case of any eligible partnership that is described in section 8.01 of this revenue procedure and that files its Monthly Closing Election during 2002, any RIC that is an eligible partner of that partnership at any time during 2002 may effect a Monthly Closing Consent by either:

(1) Complying with the procedures set forth in section 6 of this revenue procedure; or

(2) Satisfying section 6.01 of this revenue procedure at any time during 2002. In this case, the consent is effective for the month in which the partner provides the statement of consent to the custodian or manager of the partnership, unless the partner requests that the consent be effective for any other calendar month of 2002.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective on January 1, 2002. However, for the period prior to January 1, 2003, the Service will not challenge a money market fund's monthly inclusion of its distributive share of partnership items described in § 702(a) and guaranteed payments described in § 707(c) in a manner similar to that described in section 4 of this revenue procedure, provided that, had this revenue procedure been in effect at the time of the inclusion, (1) the partnership to which the items and payments are attributable would have been an eligible partnership, and (2) the partner would have been an eligible partner.

SECTION 10. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1768. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information is in sections 4, 5, and 6 of this revenue procedure. This information is required to inform the Service which partners and partnerships are making the designated election and to report income appropriately. The collection of information is required to obtain a benefit. The likely respondents are businesses.

The estimated total annual reporting and recordkeeping burden is 12000 hours.

The estimated annual burden per respondent/recordkeeper is 12 hours. The estimated number of respondents and recordkeepers is 1000.

The estimated annual frequency of responses (used for reporting requirements only) is once.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 11. DRAFTING INFORMATION

The principal author of this revenue procedure is David A. Shulman of the Office of the Associate Chief Counsel (Passthroughs and Special Industries) . For further information regarding this revenue procedure contact David A. Shulman at 202-622-3080 (not a toll free call).