

## Internal Revenue Service

## Department of the Treasury

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Date:

December 13, 2000

### LEGEND

Fund A =

Fund B =

Distributor =.

State A =

Dear:

This letter is in reply to your letter dated February 22, 2000, and subsequent correspondence, requesting a ruling that the distribution fees of Fund A and Fund B (collectively referred to as "Funds") are deductible under § 162(a) of the Internal Revenue Code.

### FACTS

Funds are organized as State A business trusts and are registered under the Investment Company Act of 1940, 15 USC 80a-1, et seq., as amended (the Act), as non-diversified closed-end investment companies. Funds have qualified and elected to be taxed as regulated investment companies under part 1, subchapter M of the Code. Funds use a calendar year as their taxable year.

Funds invest primarily in interests in senior floating-rate loans made by banks and other financial institutions. Although registered as closed-end funds, Funds operate in a manner similar to open-end funds. Funds have chosen to function as interval funds under Rule 23c-3 of regulations under the Act. As interval funds, Funds are required to offer to redeem outstanding shares for their current net asset values, at periodic intervals (every 3, 6, 9, or 12 months), at a rate of 5% to 25% of outstanding shares per redemption date. Funds' prospectuses state that it is Funds' policy to offer to repurchase outstanding shares quarterly (every 3 months). This policy may only be changed by shareholder vote. Furthermore, Funds currently have pending at the Securities and Exchange Commission (SEC) a request for an exemptive order allowing

Funds to offer to repurchase outstanding shares monthly. Funds represent that they will offer to repurchase 25% of outstanding shares on each quarterly redemption date under normal market conditions. Funds also represent that they have, in the past, consistently offered to repurchase the maximum 25% of outstanding shares.

Funds represent that they would register as open-end funds if that were possible. Funds submit they more closely resemble open-end funds than closed-end funds. The salient differences between Funds and open-end funds are that open-end funds offer to redeem outstanding shares daily, as opposed to quarterly, and open-end funds have no limit on the percentage of shares that may be redeemed. Also, Funds' operations are very different from the operations of a typical closed-end fund. Most closed-end funds have an initial public offering of their shares and provide investor liquidity by listing their shares on an exchange. In general, closed-end funds do not continuously offer their shares. In contrast, Funds continuously offer their shares and do not list their shares on an exchange.

There are two reasons why Funds are unable to register as open-end funds. First, the Act restricts open-end registration to those funds that offer redeemable shares. Redeemable shares are specifically defined, for purposes of the Act, as shares that are redeemable upon the demand of the shareholder. Because shareholders of Funds may only redeem shares on the designated quarterly redemption date and in the stated percentage, Funds' shares are not considered redeemable shares under the Act. Second, the Act imposes limits on the amount of illiquid securities held by an open-end fund. Funds are unable to comply with the limitations because their primary investments are considered illiquid securities for purposes of the Act.

Funds have implemented asset-based distribution plans to pay for the sale and distribution of their continually offered shares. Under the distribution plans, Funds pay annual fees to Distributor as compensation for the services and expenses of Distributor in distributing shares of Funds. The annual distribution fees accrue daily at a rate of .70% per year of Funds' daily net asset value and are paid monthly to Distributor to enable Distributor to recoup its costs in distributing Funds' shares. Funds have been granted exemptive relief pursuant to Rules 17d and 17d-1 of regulations under the Act, permitting them to impose their asset-based distribution fees in a manner consistent with section 270.12b-1 of regulations under the Act (Rule 12b-1 fees) as if Funds were open-end funds. In Release No. 34-42965, the SEC stated that "interval funds, because their manner of financing the distribution of shares are more similar to that of open-end funds, are more properly regulated by NASD Conduct Rule 2830, which regulates the distribution and sales charges of open-end funds."

## **LAW & ANALYSIS**

In general, stock issuance expenses are capital expenditures, not deductible under § 162. See General Bancshares Corp. v. Comm'r, 326 F.2d 712 (8<sup>th</sup> Cir. 1964). However, Rev. Rul. 73-463, 1973-2 C.B. 34, provides an exception to the general rule.

Rev. Rul. 73-463 holds that stock issuance expenses of an open-end investment company, not incurred in the initial 90-day offering period, are deductible as ordinary and necessary business expenses. Rev. Rul. 94-70, 1994-2 C.B. 17, amplifies Rev. Rul. 73-463 and holds that Rule 12b-1 fees are indistinguishable from the stock issuance expenses deductible under Rev. Rul. 73-463.

In ruling that stock issuance costs of open-end funds are deductible, Rev. Rul. 73-463 distinguishes open-end funds from other corporations. Rev. Rul. 73-463 bases the exception, in part, on the fact that, unlike other corporations, open-end funds face the “constant possibility of withdrawal of part or all of capital by means of the redemption of stock.” Rev. Rul. 73-463. The revenue ruling concludes that because the funds provide for redemption of stock, the resulting continuous capital raising efforts are an essential part of their day to day business. As day to day business expenses, they are deductible under § 162.

On its face, Rev. Rul. 73-463 only applies to open-end funds; the revenue ruling does not expressly consider interval funds. However, the facts and representations submitted by Funds demonstrate that Funds are similar in many respects to open-end funds. There is the possibility that Funds’ capital will be withdrawn by means of Funds’ quarterly offers to repurchase a portion of outstanding shares, as described above. Furthermore, Funds continuously offer their shares to replace the shares that have been repurchased. The offering of shares is a daily activity. Accordingly, the reasoning underlying the holding of Rev. Rul. 73-463 is applicable to Funds.

Having determined that the reasoning and holding in Rev. Rul. 73-463 is applicable to Funds, it follows that Rev. Rul. 94-70 is applicable to Funds’ distribution fees. Although Funds’ distribution fees are not technically Rule 12b-1 fees, they are imposed in a manner consistent with Rule 12b-1 fees.

### **CONCLUSION**

Based on the facts submitted and representations made by Funds, the distribution fees of Fund A and Fund B are deductible under § 162, subject to the limitations contained in Rev. Rul. 73-463 and Rev. Rul. 94-70 concerning the initial 90-day offering period.

Except as specifically ruled upon herein, we express no opinion concerning any federal tax consequences relating to the facts herein under any other section of the Code or regulations.

This ruling is directed only to Fund A and Fund B. Under section 6110(k)(3) of the Code, this ruling may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax return of Fund A and Fund B for the taxable years that include the transaction described in this letter.

Sincerely,  
Acting Associate Chief Counsel  
Financial Institutions & Products  
By: Alvin J. Kraft  
Chief, Branch 1

Enclosures:

Copy of this letter  
Section 6110 Copy