

## Section 851.—Definition of Regulated Investment Company

26 CFR 1.851-2: Limitations.  
(Also § 851(b)(3).)

**Regulated investment company (RIC).** This ruling provides that, for purposes of qualifying as a regulated investment company (RIC) under the tax law, a RIC shall treat its investment in refunded bonds as an investment in Government securities, to the extent that the acquisition of the refunded bonds would be treated under Rule 5b-3 under the Investment Company Act of 1940 as an acquisition of the Government securities placed in escrow to fund payment of principal and interest on the refunded bonds.

### Rev. Rul. 2003-84

#### ISSUE

If one or more government securities have been placed in escrow to fund payment of principal and interest on a bond and if Rule 5b-3, 17 CFR 270.5b-3, under the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.* (“the 1940 Act”), would treat acquisition of the bond as an acquisition of a Government Security within the meaning of the 1940 Act, is the bond a government security for purposes of § 851(b)(3)?

#### FACTS

R, a domestic corporation, is registered under the 1940 Act as a diversified management company and elects to be treated as a RIC under subchapter M, part 1, of the Code. R invests primarily in bonds issued by states and municipalities.

R invests in certain bonds that, together with other bonds (collectively, the “refunded bonds”), have been refunded through a transaction in which Government Securities, as defined in § 2(a)(16) of the 1940 Act, were placed in escrow for the purpose of providing the funds needed to make all future payments of principal and interest on the refunded bonds. Pursuant to an agreement between the issuer of the refunded bonds and the escrow agent,

the deposit in escrow is irrevocable, and the Government Securities are pledged only to payment of the debt service of the refunded bonds. The escrow agreement prohibits any substitution for the deposited Government Securities unless the substituted securities are also Government Securities. Either the refunded bonds have received the highest rating from a nationally recognized statistical rating organization, or an independent certified public accountant has certified to the escrow agent that the escrowed securities will satisfy all scheduled payments of principal, interest, and applicable premiums on the refunded bonds.

Section 5(b)(1) of the 1940 Act imposes certain asset diversification requirements on diversified investment companies for purposes of the securities laws. To be classified as a diversified investment company under § 5(b)(1), a fund is required to invest at least 75 percent of its assets in cash and cash items, Government Securities, securities of other investment companies, and other securities generally limited in respect of any one issuer to an amount not greater than 5 percent of the value of its total assets and to not more than 10 percent of the outstanding voting securities of the issuer. The remaining 25 percent of the fund's assets may be invested in any manner.

Section 2(a)(16) of the 1940 Act defines the term Government Security for purposes of the 1940 Act as meaning—  
[A]ny security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing.

15 U.S.C. 80a-2. The statute does not make any specific reference to refunded securities. Effective August 15, 2001, however, the term Refunded Security is defined, and the treatment of Refunded Securities is governed, by Rule 5b-3. See Securities and Exchange Commission (SEC) Release No. IC-25058, 66 FR 36156 (July 11, 2001). This rule applies if a fund acquires a Refunded Security, that is, a security the payment of which has been fully funded within the meaning of Rule 5b-3(c)(4) by escrowed Government Securities. “For purposes of section 5 of

the [1940] Act . . . , the acquisition of a Refunded Security is deemed to be an acquisition of the escrowed Government Securities.” Rule 5b-3(b). The effect of this Rule is that investments in Refunded Securities are treated as investments in Government Securities for purposes of the definition of a diversified investment company in section 5 of the 1940 Act.

#### LAW AND ANALYSIS

Section 851(b) provides that certain requirements must be satisfied in order for a domestic corporation to be taxed as a RIC under subchapter M, part I. Section 851(b)(3) imposes certain asset diversification requirements with respect to a corporation's total assets that must be satisfied as of the close of each quarter of the corporation's taxable year.

Section 851(b)(3)(A) requires that at least 50 percent of the value of a corporation's total assets must be represented by cash and cash items (including receivables), Government securities, securities of other RICs, and other securities generally limited in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the corporation and to not more than 10 percent of the outstanding voting securities of such issuer.

Section 851(b)(3)(B) provides that not more than 25 percent of the corporation's total assets may be invested in the securities (other than Government securities and the securities of other RICs) of any one issuer, or of two or more issuers that the corporation controls and that are determined, under regulations, to be engaged in the same or similar trades or businesses or related trades or businesses.

Section 851(c)(5) provides that, for purposes of § 851(b)(3), all terms not specifically defined in § 851(c) shall have the same meaning as when used in the 1940 Act, as amended. The term “government security” is not specifically defined in § 851.

The RIC diversification rules of subchapter M are substantially similar in structure and purpose to those of the 1940 Act. Both sets of rules impose numerical limitations on the percentages and types of assets that may be held by an investment company. Both are intended to protect the investor from the risks of

loss and of illiquidity inherent in the concentration of assets in the securities of a single or a small number of issuers. *See* H.R. Rep. No. 2020, 86th Cong., 2d Sess. 820–26. In view of the commonality of structure and purpose of both sets of rules and in view of the need for RICs simultaneously to comply with both, the diversification provisions of the Code and those of the 1940 Act should be interpreted consistently.

As a result of Rule 5b–3(b), *R*'s investment in certain of the refunded bonds is treated as an investment in Government Securities for purposes of the diversification requirements under the 1940 Act. Accordingly, for each calendar quarter the end of which occurs after the refunding transaction that created the escrow deposit, the refunded bonds are government securities for purposes of § 851(b)(3), regardless of whether the RIC acquired the refunded bonds before or after that refunding transaction.

## HOLDING

For purposes of applying the diversification requirements under § 851(g)(3), a RIC's investment in refunded bonds is an investment in government securities to the extent that an acquisition of the refunded bonds would be treated by Rule 5b–3 as an acquisition of the Government Securities that were deposited in the escrow for the bonds.

## DRAFTING INFORMATION

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