MEMO# 24039

December 22, 2009

Regulated Investment Company Modernization Act of 2009 Introduced

[24039]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 68-09 RE: REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2009 INTRODUCED

We are very pleased to inform you that legislation to modernize the tax rules applicable to regulated investment companies ("RICs") was introduced on December 16, 2009 in the U.S. House of Representatives by Ways and Means Committee Chairman Charles Rangel (D-NY) and three other members of the Ways and Means Committee. [1] The bill (H.R. 4337) contains 16 separate substantive sections and is estimated to cost only $188 million over the next ten years.

I. Capital Loss Carryovers

The bill would provide RICs with an unlimited ability to carry forward the net capital losses incurred on portfolio transactions. This change would apply to net capital losses for taxable years beginning after the date that the bill is enacted into law ("the date of enactment").

II. Gross Income and Asset Diversification Tests

The bill would treat income from commodities as qualifying income for purposes of the gross income test (in Code section 851(b)(2)) that, among others, must be met if a fund is to qualify for the tax treatment provided by Subchapter M of the Code. This change would apply to RIC taxable years beginning after the date of enactment.

The bill also contains two “savings provisions” for inadvertent failures to meet Subchapter M qualification tests. These savings provisions would apply to RIC taxable years for which the due date of the return (determined with regard to extensions) is after the date of enactment.

A RIC that inadvertently fails to meet the gross income test of Code section 851(b)(2) could cure that failure by paying a tax equal to the amount by which it failed the test.

Two separate rules are provided for inadvertent failures to meet the asset diversification test of Code section 851(b)(3). If a RIC fails the asset diversification test by a de minimis amount and comes into compliance within six months after identifying the failure, the RIC will be treated as satisfying the test with no penalty. If the failure is by more than a de minimis amount, and is due to reasonable cause, the RIC can avoid disqualification by notifying the IRS of the failure, disposing of the assets causing the failure, and paying an excise tax equal to the greater of (i) $50,000 or (ii) the highest corporate tax rate times the net income from the assets causing the failure during the period of failure.

III. Dividends and Other Distributions

The bill would make numerous improvements to the rules that apply to RIC dividends and other distributions. These changes would apply, except as noted otherwise, to distributions in RIC taxable years beginning after the date of enactment.

First, the bill would modify the dividend designation requirements and allocation rules applicable to RICs. The requirement that a RIC send written designation notices to shareholders within sixty days after the end of the RIC’s taxable year would be eliminated. These designations currently are required for capital gain dividends, exempt-interest dividends, foreign tax credits, credits for tax credit bonds, the dividends received deduction, interest-related dividends, and short-term capital gain dividends.

The bill’s allocation rules would apply to any RIC with a taxable year that overlaps two calendar years (a “non-calendar-year RIC”). Specifically, the bill generally would permit non-calendar-year RICs that overdistribute their net capital gain over the course of the taxable year to allocate this gain first to support capital gain dividends distributed in the portion of the taxable year ending on December 31. Similar rules would apply to exempt-interest dividends, short-term capital gain dividends, and interest-related dividends. These allocation rules would minimize the number of situations in which RICs are required to send amended year-end tax information (on IRS Forms 1099) to shareholders and the IRS; depending on when these amended IRS Forms are received, shareholders sometimes can be forced to amend their IRS Form 1040 individual income tax returns. The changes made by this section would apply to taxable years beginning after the date of enactment.

Second, the bill would permit a RIC to take into account in calculating earnings and profits those deductions that otherwise are disallowed under Code sections 265 and 171(a)(2) because they are associated with earning tax-exempt income. After the change, the shareholders in a RIC investing in municipal bonds that distributes what, economically, is a return of capital would be treated as having received a return of capital and not, as under current law, a taxable dividend. This change would apply to taxable years beginning after the date of enactment.

Third, the bill would permit a "qualifying" upper-tier fund in a fund-of-funds structure (i.e., a RIC that invests at least 95% of its assets in cash, cash items, and interests in other RICs) to pass through to its shareholders foreign tax credits and tax-exempt interest received from lower-tier funds without itself meeting the otherwise-applicable requirement that 50% or more of the RIC's assets be in qualifying assets. This change would apply to taxable years beginning after the date of enactment.

Fourth, the bill would modify the spillover dividend requirements of Code section 855; these rules permit a RIC to distribute its remaining taxable income after the close of its taxable year and claim a dividends paid deduction for that taxable year. Specifically, under the bill, the spillover dividend must be made with the first subsequent dividend payment of the same type and on or before the 15th day of the ninth month following the close of the RIC's taxable year (or the later due date for filing its return if an extension has been received).

Fifth, the bill would allocate a non-calendar-year RIC's earnings and profits first to distributions made on or before December 31 of that taxable year and then to distributions made thereafter.   This change would minimize the possibility that a RIC would need to send shareholders amended IRS Forms 1099 to report a return of capital during the portion of the RIC's taxable year ending on December 31.

Sixth, the bill would modify in two ways the tax treatment of redemptions of RIC shares. The first change would apply to all publicly-offered RICs that issue shares redeemable upon demand. Under the bill, all such distributions in redemption of stock would be treated as exchanges. This change addresses the technical possibility that redemptions, in certain isolated situations, could be treated as dividends. The second change would apply to RICs in fund-of-funds structures. Under the bill, any loss incurred by the upper-tier fund on the redemption of its shares in the lower-tier fund would not be subject to deferral under the rules that defer losses on transactions between related parties. This change addresses the possibility that losses incurred by the upper-tier fund attributable to shares in the lower-tier funds must be deferred, perhaps indefinitely, while gains are recognized currently. These changes would apply to distributions after the date of enactment.

Seventh, the bill would repeal the preferential dividend rule of Code section 562(c) for publicly-offered RICs.

Eighth, the bill would provide RICs with an election to defer certain late-year losses for purposes of determining taxable income and earnings and profits. Specifically, the bill would allow a RIC to treat a post-December loss (or, in the case of capital gains, a post-October 31 loss) as arising on the first day of the RIC’s next taxable year. These changes would apply to taxable years beginning after the date of enactment.

IV. Excise Tax

The bill would expand the current-law exemption from the Code section 4982 excise tax distribution requirements for RICs that have as shareholders only certain types of tax-exempt investors. Under the bill, the exemption would apply to RICs whose shareholders include additional types of tax-exempt entities, including additional types of retirement plans and section 529 plans. This change would apply to calendar years beginning after the date of enactment.

The bill also would modify the excise tax requirements to treat all ordinary income or loss attributable to the sale, exchange, or other disposition of (or termination of a position with respect to) property after October 31 as arising on the first day of the next calendar year for excise tax distribution purposes. This change would apply to calendar years beginning after the date of enactment.

The bill would allow any RIC that pays estimated tax (such as a RIC investing in municipal bonds that chooses to pay tax on any market discount on the bonds) to take these tax payments into account in determining its excise tax liability. This change would apply to calendar years beginning after the date of enactment.

V. Other Provisions

The bill would modify the consequences of paying a deficiency dividend under Code section 860 by eliminating the requirement that a RIC pay, in addition to an interest charge, a supplemental penalty equal to the lesser of the interest charge or 50% of the amount of the deficiency dividend. This change would apply to taxable years beginning after the date of enactment.

Finally, the bill would modify the so-called “sales load basis deferral” rules of Code section 852(f) to limit the rule’s application to cases in which a taxpayer makes a reinvestment triggering the rule by January 31 of the calendar year following the year in which the redemption of the initial investment occurred. The change – by shutting off the sales load basis deferral rule after January 31 – effectively will eliminate the possibility that the sales load basis deferral rule will force a shareholder to amend an individual income tax return. This change would apply to taxable years beginning after the date of enactment.

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Attachment

endnotes

[1] The bill language is found at http://waysandmeans.house.gov/media/pdf/111/Rangel_075_xml.pdf; a summary of the bill is found at http://waysandmeans.house.gov/media/pdf/111/MA_Summary.pdf; a technical summary of the bill is found at http://waysandmeans.house.gov/media/pdf/111/RIC_Tech.pdf.
