

MEMO# 30651

March 23, 2017

Tax Legislative Issues Discussed During March Tax Committee Call

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The Tax Committee recently discussed on its monthly conference call possible legislative proposals specific to regulated investment companies ("RICs") that could be advanced in the context of comprehensive tax reform.

The first set of issues arises from proposals to require taxpayers to mark to market all derivatives, with gains and losses characterized as ordinary income or losses.[\[1\]](#) These include:

1. Permit RICs to Carry Forward Net Operating Losses ("NOLs")

Issue: RICs currently are not permitted to carry forward NOLs. Permitting NOL carryforwards for RICs will be especially crucial if derivatives are marked to market, and the gains/losses are treated as ordinary. Otherwise, RICs and their shareholders will be unduly harmed.

Proposal: Allow RICs the same NOL carryover rules that apply to other corporate entities under current law or as amended in accordance with the GOP Blueprint. NOL carryforwards originally were proposed as part of the RIC Modernization Act of 2010 but were not included in the final legislation.

2. Clarify Calculation of Mark-to-Market Gains/Losses for Excise Tax Purposes

Issue: For excise tax purposes, capital gains and other income/gains that are not recurring or predictable are calculated using an October 31 year-end, to ease calculation and payment of a RIC's excise tax liability.

Proposal: Amend section 4982 to clarify that all income and loss from derivatives that are marked to market (including any payments on the derivatives) are calculated as of 10/31, similar to capital gains and other mark-to-market regimes, for purposes of calculating a RIC's excise tax liability for the

calendar year.

3. Apply Business Hedging Regime to Portfolio Hedging

Issue: RICs use derivatives to hedge various non-tax risks in their portfolios. Current proposals would require taxpayers to mark to market both the derivative and the underlying asset being hedged, treating any gains and losses as ordinary.

Proposal: Permit RICs to use a hedging regime similar to the current business hedging regime, in which the character and timing of hedges are driven by the underlying asset.

4. Allocation of Earnings and Profits to Capital Gain Distributions

Issue: Section 19 of the Investment Company Act of 1940 only permits RICs to make two capital gain distributions per year (and one very small third distribution). If derivatives are marked to market annually, late-year losses in the value of a derivative could affect the character of income that a RIC has already distributed, resulting in multiple capital gain distributions.

Proposal: Amend section 316 to permit RICs to allocate E&P first to any distributions characterized as capital gain dividends, to avoid inadvertent violations of Section 19.

The Committee also discussed other RIC-specific proposals addressing issues arising from Subchapter M, the excise tax under section 4982, Subchapter C, and other sections of the Internal Revenue Code. These include:

1. Permit Investment in Commodities

Issue: At least 90% of a RIC's gross income must come from certain specified sources; commodities are not one of those sources of "good income." Thus, RICs are limited in their ability to invest directly in commodities, denying shareholders the most cost-effective access to such investments.

Proposal: Amend section 851(b)(2) to provide that commodities generate income that qualifies for the 90% good income test. This proposal was included in the version of the RIC Modernization Act of 2010 that passed the House of Representatives but was deleted from the final legislation.

2. Clarify Application of Excise Tax Rules with Respect to Certain Deemed Dividends from Corporations

Issue: The corporate tax rules contain a number of provisions that can recharacterize certain distributions as dividends (i.e., sections 302, 304, and 356). Section 305 also may deem a shareholder to have a distribution with respect to convertible securities that it holds even if no actual distribution has been made. These types of distributions are unpredictable and often occur at year-end, making excise calculations difficult.

Proposal: Amend section 4982(e)(5) to refer to ordinary “income” rather than ordinary “gain.” This would ensure that certain deemed dividends resulting from corporate actions would be calculated on a 10/31 basis for excise tax purposes.

3. Provide “Fiscal Year-to-Date” Safe Harbor for Calculating Excise Tax Liability

Issue: The excise tax rules, which require RICs to distribute substantially all of their income and gains by the end of the calendar year, create significant complexities for mutual funds at year-end, including the need to keep separate books and records for ordinary income and capital gains.

Proposal: Amend section 4982 to provide a “safe harbor,” which would allow a RIC to choose to calculate its excise tax liability by using the amount of taxable income calculated for income tax purposes (on a fiscal-year basis) through the end of the calendar year. This so-called “Murphy Proposal” essentially follows the transition relief that was provided when section 4982 was added to the Internal Revenue Code in 1986.

4. Revise Deficiency Dividend Rules to Account for Tax-Exempt Shareholders

Issue: If a RIC discovers that it has underpaid its required distribution in a given year, it may make a “deficiency dividend” in a later year. The RIC must pay interest on the total amount of the deficiency dividend that is paid.

Proposal: Amend section 860 to provide that RICs must only pay interest on the total amount of the deficiency dividend that is paid to taxable shareholders (thus excluding amounts paid to any non-taxable shareholders). Alternatively, clarify that the IRS has the authority to enter into closing agreements to permit such results when warranted.

5. Rationalize Application of Section 382 to RIC Shares Held by 401(k) Plans and Insurance Company Separate Accounts

Issue: RICs are subject to the loss limitation rules in section 382 and 383. Under these rules, a section 401(k) plan and stock held in insurance company separate accounts underlying variable annuities and variable life insurance policies are treated as held by one owner. They thus qualify as “5-percent shareholders” and potentially limit a RIC’s ability to utilize capital losses.

Proposal: Amend section 382 to provide that participants in section 401(k) plans and beneficial owners of insurance company separate accounts are treated as direct owners of fund shares that they beneficially own through the plan or separate account. This change was included in the Institute’s original proposals for the RIC Modernization Act of 2010 but was not included in the legislative language.

6. Exempt Publicly Offered RICs from Personal Holding Company Definition

Issue: A RIC can fall within the definition of “personal holding company” under section 542, even when it is publicly offered, if more than 50% of the value of its

outstanding stock is held directly or indirectly for the benefit of 5 or fewer individuals. This can lead to difficulties if the RIC makes distributions in liquidation under section 562, because the RIC may not treat those distributions as dividends for purposes of computing the dividends paid deduction.

Proposal: Amend section 542 to exclude publicly offered RICs (as defined in section 67(c)(2)(B)) from the definition of “personal holding company.”

7. Update Section 817(h) to Permit Increased Investment in US Treasuries

Issue: Segregated asset accounts underlying variable annuity and variable life insurance products must satisfy the diversification requirements of section 817(h). Section 817(h)(3) provides a special rule that treats segregated asset accounts related to variable life insurance contracts as adequately diversified to the extent that they are invested in securities issued by the US Treasury. The rule does not apply with respect to variable annuity products.

Proposal: Amend section 817(h) to treat segregated asset accounts with respect to variable annuity products as adequately diversified to the extent that they are invested in US Treasuries, thus equalizing the treatment with variable life insurance contracts.

8. Clarify that Subpart F and QEF Inclusions Can Constitute Good Income

Issue: The flush language in section 851(b) provides that subpart F and QEF inclusions will constitute dividends for purposes of the good income test to the extent that the CFC or PFIC makes a distribution. The IRS has taken the position in proposed regulations that subpart F and QEF inclusions thus cannot qualify as good income absent such a distribution, even if the investment in the CFC or PFIC is related to the RIC’s business of investing in stock, securities, or foreign currencies.[\[2\]](#)

Proposal: Delete the flush language in section 851(b) that provides that subpart F and QEF inclusions will constitute dividends to the extent that there is a distribution out of earnings and profits attributable to the amount of the inclusion.

9. Allow RICs to Flow Through Short-Term Capital Gains

Issue: Although RICs may pay long-term capital gain dividends to their shareholders, short-term capital gains are treated as ordinary dividends when paid to RIC shareholders. RIC shareholders thus receive different treatment for such gains if invested directly or through a RIC.

Proposal: Amend section 852(b) to permit RICs to pay short-term capital gain dividends to their shareholders.

10. Increase Permitted RIC Investment in Publicly Traded Partnerships

Issue: A RIC currently may invest no more than 25% of its total assets in publicly traded partnerships. Investment managers thus often must invest in PTPs

through taxable C corporations if they wish to provide increased exposure to PTPs.

Proposal: Repeal section 851(b)(3)(B)(iii) to eliminate the 25% limitation on investment in PTPs.

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endnotes

[1] See Institute Memorandum No. 30280, dated September 29, 2016, which can be found here: https://www.ici.org/my_ici/memorandum/memo30280.

[2] See Institute Memorandum No. 30493, dated December 22, 2016, which can be found here: https://www.ici.org/my_ici/memorandum/memo30493.

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