

**MEMO# 29897**

May 6, 2016

# **IRS Guidance on Money Market Fund Reform Tax Issues -- Variable Insurance Products and Adviser Contributions**

[29897]

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TO: ACCOUNTING/TREASURERS MEMBERS No. 10-16  
BROKER/DEALER ADVISORY COMMITTEE No. 14-16  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 12-16  
OPERATIONS MEMBERS No. 12-16  
SEC RULES COMMITTEE No. 21-16  
SMALL FUNDS MEMBERS No. 18-16  
TAX MEMBERS No. 9-16  
TRANSFER AGENT ADVISORY COMMITTEE No. 18-16  
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 9-16 RE: IRS GUIDANCE ON  
MONEY MARKET FUND REFORM TAX ISSUES -- VARIABLE INSURANCE PRODUCTS AND  
ADVISER CONTRIBUTIONS

We are pleased to report that the Internal Revenue Service ("IRS") and the Treasury Department have issued guidance addressing two issues raised by the Securities and Exchange Commission's ("SEC's") money market fund reform. [Notice 2016-32](#) provides an alternative diversification requirement under section 817(h) for a segregated asset account that invests in a government money market fund. [Rev. Proc. 2016-31](#) addresses the tax treatment of contributions to a money market fund by the investment adviser in preparation for compliance with the new floating net asset value ("NAV") rules.

## **Notice 2016-32**

The Institute's members have raised concerns regarding the availability of government securities that are money market fund-eligible securities under SEC Rule 2a-7. In particular, members have been concerned about the ability of segregated asset accounts underlying variable insurance products to satisfy the diversification requirements of section 817(h) if they also wish to qualify as a government money market fund under Rule 2a-7. The Institute thus requested guidance providing a safe harbor for such segregated assets accounts. [\[1\]](#)

In response to the Institute's request, the IRS and Treasury department issued guidance

providing an alternative diversification requirement under Treas. Reg. §1.817-5 for a segregated asset account that invests in a government money market fund. Specifically, a segregated asset account within the meaning of Treas. Reg. § 1.817-5(e) is adequately diversified for purposes of section 817(h) if:

1. No policyholder has investor control; and
2. Either
  - a. The account itself is a government money market fund under Rule 2a-7(a)(14); or
  - b. The account invests all of its assets in an “investment company, partnership, or trust” as defined in Treas. Reg. § 1.817-5(f)(1) that satisfies the criteria of Treas. Reg. § 1.817-5(f)(2) (i.e., an insurance-dedicated fund) and qualifies as a government money market fund under Rule 2a-7(a)(14).

The IRS and Treasury Department intend to revise the regulations under Treas. Reg. § 1.817-5 to permit variable insurance products to be able to offer government money market funds as an investment option. Until then, taxpayers may rely upon the guidance in this Notice.

### **Rev. Proc. 2016-31**

Another issue raised by money market fund reform is the tax treatment of contributions to a money market fund by its investment adviser. We understand that an adviser may decide to contribute cash to an existing money market fund to bring the shadow NAV up to \$1.0000 before the compliance date for the SEC floating NAV rule. Although for book purposes this contribution would be treated as additional paid-in capital, with no resulting gain or income to the fund, the tax treatment is unclear. [\[2\]](#) The Institute thus asked the IRS and Treasury Department to provide guidance regarding such adviser contributions. [\[3\]](#)

Rev. Proc. 2016-31 provides temporary relief for money market funds that receive a “top up” contribution. The guidance applies only to a top up contribution that is received by a money market fund as part of a transition to implement the floating NAV reform before the October 14, 2016 compliance deadline. The revenue procedure provides that the Service will not challenge a money market fund’s treatment of such a contribution as an amount that is included in investment company taxable income (“ICTI”) for purposes of section 852(b)(2) but is excluded from ICTI for purposes of section 852(a)(1). In other words, the money market fund may exclude the amount of the adviser contribution for purposes of determining its distribution requirements for income tax purposes, but it must pay federal income tax on the amount of the adviser contribution. The revenue procedure then includes an example illustrating the application of the guidance.

Example: Fund is a March 31 money market fund that will become a floating NAV money market fund by October 14, 2016. As of April 22, 2016, the fund has 500 million outstanding shares and assets with a fair market value of \$498,000,000. The fund’s shadow NAV on April 22 is \$0.9960. On April 25, 2016, the fund’s adviser makes a \$3,000,000 contribution to the fund. [\[4\]](#) During its taxable year ending on March 31, 2017, the fund has \$2,000,000 in ordinary income from securities in its portfolio and distributes \$2,000,000 in ordinary dividends to its shareholders. The fund has no capital gains or losses. Fund elects under section 4982(c)(4) to make an estimated tax payment of \$1,020,000 during the 2016 calendar year with respect to the fund’s taxable year ending March 31, 2017. This amount reflects the tax under section 852(b)(1) on \$3,000,000 of the fund’s ICTI for that taxable year.

For its taxable year ending on March 31, 2017, the fund has ordinary income of \$5,000,000 (\$2,000,000 from its portfolio plus the \$3,000,000 adviser contribution). For purposes of section 852(b)(2), the fund's ICTI for that year is \$3,000,000, because the fund has a \$2,000,000 deduction for dividends paid. The tax on \$3,000,000 is \$1,020,000, which was satisfied by the estimated tax payment in 2016.

For purposes of section 852(a)(1), the fund treated its ICTI as being \$2,000,000 (excluding the adviser contribution and disregarding the dividends paid deduction). Because the fund distributed \$2,000,000 of dividends in the taxable year ending March 31, 2017, it distributed over 90% of the amount that it is treating as ICTI for purposes of section 852(a). Consistent with the revenue procedure, the IRS will not assert that the fund failed to satisfy the distribution requirement in section 852(a)(1).

Under section 4982(c)(4)(A)(i), the fund's distributed amount for 2016 is increased by the \$3,000,000 on which the fund made a \$1,020,000 estimated tax payment. Thus, section 4982 does not impose an excise tax on the fund for 2016. Under section 4982(c)(4)(A)(ii), the fund's distributed amount for 2017 will be decreased by \$3,000,000.

After payment of \$1,020,000 of income taxes, the contribution of \$3,000,000 increased the value of the fund's portfolio to \$499,980,000. After this increase, the fund's NAV is \$1.0000 (rounded to the nearest basis point).

Importantly, as shown by the example, a fund must elect under section 4982(c)(4) to make an estimated tax payment equal to the amount of tax due on the adviser contribution to avoid excise tax liability for 2016 resulting from the adviser contribution. If the fund makes such an estimated tax payment in the current calendar year, it may include the amount of the estimated tax payment when determining the fund's 2016 excise tax liability.

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#### **endnotes**

[1] See Institute Memorandum ([29529](#)) dated December 7, 2015.

[2] One possible approach would be to treat the contribution as short-term capital gain. If the fund does not have sufficient losses to offset the amount of the contribution, however, the fund would have net capital gain, some or all of which it must then either distribute to its shareholders or retain and be subject to corporate-level tax. Alternatively, the fund could treat the contribution as a non-shareholder contribution. Although the payment would not result in immediate gain or income to the fund, it would result in a basis reduction in any assets held by the fund twelve months after the contribution is received under section 362(c). The fund thus would have capital gain equal to the amount of the contribution when those assets are sold. Again, any resulting net gain recognized would require the fund to make a distribution or retain and pay tax on all or part of such gain.

[3] See Institute Memorandum ([29051](#)) dated June 4, 2015.

[4] Note that only \$2,000,000 is needed to bring the fund's NAV up to \$1.0000.

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