

MEMO# 30017

July 7, 2016

IRS Releases Final Regulations on NAV Method for Money Market Funds

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TO: ACCOUNTING/TREASURERS MEMBERS No. 16-16
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BROKER/DEALER ADVISORY COMMITTEE No. 21-16
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 15-16
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TAX MEMBERS No. 12-16
TRANSFER AGENT ADVISORY COMMITTEE No. 26-16
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 14-16 RE: IRS RELEASES
FINAL REGULATIONS ON NAV METHOD FOR MONEY MARKET FUNDS

The Treasury Department and the Internal Revenue Service (“IRS”) have released [final regulations](#) implementing the Net Asset Value, or “NAV,” Method of tax accounting for shares in money market funds. [\[1\]](#) The IRS also issued [Rev. Proc. 2016-39](#), which provides procedures by which a taxpayer may obtain the automatic consent of the IRS Commissioner to change to or from the NAV Method. We are pleased to report that the final regulations include several changes, described in more detail below, that were recommended by the Institute. [\[2\]](#)

The final regulations do not address, however, two other requests that were made by the Institute. Specifically, the guidance does not clarify the proper tax treatment by a money market fund of liquidity fees that it imposes, or whether funds will have sufficient earnings and profits to treat a distribution of excess liquidity fees as a dividend. The preamble to the final regulations notes that these requests do not relate directly to the NAV Method and therefore are not addressed in the final regulations. The Treasury Department and the IRS may consider guidance on these issues in the future.

Final Regulations on the NAV Method

Application to Stable NAV Money Market Funds

The proposed regulations permitted use of the NAV Method only for shares in floating NAV money market funds. In most cases, shareholders in stable NAV money market funds will not need to use the NAV Method because they will not have gains or losses on sales of those shares. The Institute noted, however, that investors in stable NAV money market funds could have losses if the stable NAV money market fund charges a liquidity fee. Similarly, shareholders in stable NAV funds could have gains or losses if the fund “breaks the buck” on either the upside or the downside. The Institute thus recommended that the IRS permit taxpayers to use the NAV Method for shares in stable NAV funds, if necessary. The IRS and Treasury Department agreed with this change. Therefore, the final regulations permit taxpayers to apply the NAV Method to shares in stable NAV money market funds. [\[3\]](#)

The Institute also asked the IRS to extend the wash sale exception in Rev. Proc. 2014-45 to losses on shares in stable NAV money market funds. Again, a shareholder could have a loss upon the sale of shares in a stable NAV money market fund if the fund charges a liquidity fee. Such a loss generally would be deferred under the wash sale rules of section 1091 if the shareholder purchased additional shares within 60 days of the sale. The preamble to the final regulations notes that, under the NAV Method, the wash sale rules are not implicated, because net gain or loss is determined for each computation period, and no gain or loss is determined for any particular redemption. Because the NAV Method can be used to prevent wash sales on shares in stable NAV money market funds, the IRS is not extending the exemption in Rev. Proc. 2014-45 to stable NAV money market funds.

Use of NAV Method across Accounts

The proposed regulations required a taxpayer who chooses to use the NAV Method to apply that method to all of its investments in floating NAV money market funds, regardless of whether those shares were in different funds, or whether they were shares of the same fund but held in different accounts. The Institute recommended that the IRS and Treasury Department permit taxpayers to apply the NAV Method on an account-by-account basis. The government adopted our suggestion, and thus the final regulations permit money market fund shareholders to use different methods of accounting (i.e., NAV Method or a realization method) for shares in different money market funds or for shares in a single money market fund held in different accounts. [\[4\]](#)

Excise Tax Implications

The Institute asked the IRS and Treasury Department to clarify that (1) a regulated investment company (“RIC”) that holds money market fund shares may use the NAV Method for excise tax purposes, and (2) a RIC that uses the NAV Method is permitted to use the one-year period from November 1 to October 31 as its computation period for excise tax purposes. In response to this request, the final regulations provide that the NAV Method may be used for purposes of section 4982 and that the taxable year for those purposes should be the relevant period under section 4982(e). [\[5\]](#)

The IRS and the Treasury Department, however, believe that a RIC should be consistent in its application of the NAV Method to money market fund shares for both income and excise tax purposes. The final regulations thus require a RIC that uses the NAV Method for income tax purposes to also use it for excise tax purposes, and vice versa. [\[6\]](#) The final regulations also require a RIC (other than a RIC described in 4982(f)) to use the same computation periods for both income tax and excise tax purposes. [\[7\]](#)

Thus, a RIC generally would use the one-year period ending on October 31 as its taxable year for purposes of applying the NAV Method to determine the RIC's required excise tax distribution. The RIC, however, may not use this period as a computation period for excise tax purposes if it contains days from more than one income tax year. If the RIC has a fiscal year that ends on a date other than October 31, then the RIC must divide the year into at least two computation periods for both income tax and excise tax periods. The final regulations do eliminate the requirement that computation periods be of approximately equal duration, so a RIC that uses the NAV Method may use two computation periods of different lengths. For example, a January 31 RIC that applies the NAV Method to its money market fund shares could have two computation periods, applied for both income tax and excise tax purposes: one ending on January 31, and the other on October 31.

The final regulations also provide that the NAV Method is a "specified mark to market provision" under section 4982(e)(6)(B), and therefore any ordinary gains and losses determined under the NAV Method are governed by section 4982(e)(6)(A). [\[8\]](#)

A RIC that changes to or from the NAV Method for its shares in a money market fund for income tax purposes must apply the new method for excise tax purposes starting with the first day of the RIC's income tax year of change. If that first day is not the first day of the RIC's excise tax period that ends in or with the RIC's fiscal year, then solely for purposes of calculating the RIC's required excise tax distribution for the calendar year that ends with or within the RIC's income tax year of change, the excise tax period must be bifurcated into two portions, each of which is treated as a separate taxable year. The first begins on the first day of the excise tax period and ends on the last day of the RIC's income tax year that precedes the year of change; the second begins on the first day of the excise tax year of change and ends on the last day of the excise tax period. [\[9\]](#)

Fair Market Value

The proposed regulations provided that gain or loss under the NAV Method would be determined by reference to the fair market value of the money market fund shares. The proposed regulations did not, however, define "fair market value." In response to comments by the Institute and others, the final regulations clarify that the fair market value of a share in a money market fund at the time of a transaction is presumed to be the applicable published redemption amount for the share. The published redemption amount is the published amount for which the money market fund would redeem the share (usually, the NAV per share, taking into account any corrections but not any liquidity fees). [\[10\]](#)

For purposes of determining the ending value of a taxpayer's shares for a specified computation period, the applicable published redemption amount is the last published redemption amount on the last day of that computation period. To determine the value of shares received in a redemption or exchange, the applicable published redemption amount generally would be the published redemption amount received for the shares or used to determine the consideration received in the redemption or exchange. If there is no applicable published redemption amount, or if circumstances indicate that the amount does not represent the fair market value of a share in the money market fund, the fair market value is determined on the basis of all the facts and circumstances.

Other Changes

The final regulations made two other changes to the proposed regulations. First, the final regulations clarify the aggregate amount received by a taxpayer upon redemption of

shares for purposes of determining a taxpayer's net investment for a computation period. [11] If the taxpayer receives only cash and/or other money market fund shares, the amount received is the amount of any cash plus the fair market value of any shares received. If the taxpayer receives any property other than cash or money market fund shares, the amount received is determined by reference to the fair market value of the surrendered money market fund shares.

Second, the final regulations clarify the effect on net investment of a share acquired from another person with a transferred basis. [12] If a shareholder receives a transferred basis in one or more acquired money market fund shares, and the person from whom the shareholder acquired the shares used the NAV Method, then the adjusted basis of the acquired shares will be their fair market value at the time of the acquisition. This value generally is presumed to be the next NAV published by the money market fund.

Information Reporting

The final regulations adopt, without substantive changes, the proposed regulations regarding information reporting on floating NAV money market funds. Accordingly, Treas. Reg. § 1.6045-1(c)(3)(vi) provides that the exceptions to information reporting under sections 6045, 6045A, and 6045B now apply to any RIC that is permitted to hold itself out to investors as a money market fund under Rule 2a-7 under the Investment Company Act of 1940. The new rule thus includes both stable and floating NAV money market funds.

Effective Date

The final regulations on the NAV Method itself apply to taxable years ending on or after July 8, 2016. For taxable years ending on or after July 28, 2014, and beginning before July 8, 2016, money market fund shareholders may rely upon either the proposed regulations or the final regulations.

The final regulations regarding information reporting apply to sales of money market fund shares in calendar years beginning on or after July 8, 2016. Taxpayers and brokers, however, may rely upon these rules for sales of shares in calendar years beginning before July 8, 2016.

Rev. Proc. 2016-39

Generally, a taxpayer must obtain the permission of the IRS Commissioner before changing a method of accounting for federal income tax purposes. Because the NAV Method is a method of tax accounting, taxpayers must have the IRS's consent before switching to or from the NAV Method. Rev. Proc. 2016-39 provides procedures under which taxpayers may obtain automatic consent from the IRS to make such a change.

The revenue procedure applies to taxpayers that hold shares in a money market fund, as defined in the final regulations under section 446, that wish to change their method of accounting for gain or loss on the shares from a realization method to the NAV Method or vice versa. Under this guidance, a change to or from the NAV Method is made on a cut-off basis, and, a section 481 adjustment is neither permitted nor required. A taxpayer would apply the new method to the computation of gain or loss on the shares beginning with the year of change. A taxpayer changing to the NAV Method takes a starting basis in those shares for the year of change equal to the aggregate adjusted basis of the shares at the end of the immediately preceding taxable year. A taxpayer changing from the NAV Method to a realization method must adjust the basis in the shares beginning on the first day of the

year of change to account for gain or loss previously recognized under the NAV Method.

Taxpayers seeking automatic consent under this revenue procedure may use a short Form 3115, in lieu of Form 3115, that includes the following information:

- i. The identification section of page 1 of Form 3115;
- ii. The signature section at the bottom of page 1 of Form 3115;
- iii. The designated automatic accounting method change number for such a change (the number for the NAV Method is 227);
- iv. A statement specifying whether the taxpayer is changing from a realization method to the NAV Method or from the NAV Method to a realization method; and
- v. A statement specifying the money market fund or money market funds to which the change applies (if the change does not apply to all money market funds in which the taxpayer holds shares) and, if applicable, whether the change applies only to shares held in a particular account.

A taxpayer is not required to file any Form 3115 if the taxpayer is changing to the NAV Method for shares in a stable NAV money market fund if:

- i. The taxpayer has not used the NAV Method for shares in the money market fund for any taxable year prior to the year of change; and
- ii. Prior to the year of change, either
 - a. The taxpayer's basis in each share of the money market fund has been at all times equal to the money market fund's target share price, or
 - b. The taxpayer has not realized any gain or loss with respect to shares in the money market fund.

A taxpayer may make multiple changes for the same year of change by filing a single short Form 3115. The short Form 3115 will be treated as applying to all shares that the taxpayer holds in any money market fund, unless the taxpayer specifies the money market funds to which the change applies. Similarly, if the taxpayer specifies a money market fund, the short Form 3115 will be treated as applying to all shares in that money market fund held in any account by the taxpayer, unless it specifies the accounts to which the change applies.

The revenue procedure is effective for taxable years ending on or after July 8, 2016.

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endnotes

[1] See Institute Memorandum ([28281](#)), dated July 24, 2014, for a description of the proposed regulations.

[2] See Institute Memorandum ([28478](#)) dated October 23, 2014; Institute Memorandum ([28814](#)) dated March 11, 2015.

[3] Treas. Reg. § 1.446-7(a).

[4] Treas. Reg. § 1.446-7(c)(1) and (5).

[5] Treas. Reg. § 1.446-7(b)(1)(iii).

[\[6\]](#) Treas. Reg. § 1.446-7(c)(6)

[\[7\]](#) Treas. Reg. § 1.446-7(b)(1)(iii).

[\[8\]](#) Treas. Reg. § 1.446-7(c)(7).

[\[9\]](#) Treas. Reg. § 1.446-7(c)(8)(ii).

[\[10\]](#) Treas. Reg. § 1.446-7(b)(3).

[\[11\]](#) Treas. Reg. § 1.446-7(b)(5)(ii).

[\[12\]](#) Treas. Reg. § 1.446-7(b)(5)(iii)(B).

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