COMMENT LETTER

June 28, 2002

Comment Letter to Treasury on Simplification of Tax Rules, July 2002

By Electronic and Regular Mail

June 28, 2002

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RE: Tax Simplification for Regulated Investment Companies

Dear Rob and Barbara:

The Investment Company Institute[1] applauds the Treasury Department's recent initiatives to simplify and rationalize our income tax system. Earlier this year, the Institute suggested several changes to the Internal Revenue Code that would both simplify the tax treatment of individuals investing in mutual funds and enhance incentives for individuals to accumulate and maintain adequate savings to meet long-term needs.[2] Enactment of these changes, which would provide tangible direct benefits to millions of Americans saving and investing through mutual funds, remains a top priority for the investment company industry.

The Institute also has identified the following three potential changes to the Internal Revenue Code that would simplify the tax treatment of mutual funds treated under the Code as Regulated Investment Companies (RICs).

- Simplify tax reporting to RIC shareholders by permitting electronic delivery of all tax

information returns and Subchapter M designation notices.
- Simplify the passive foreign investment company (PFIC) rules by eliminating application of the PFIC asset test to portfolio investors, including RICs.
- Simplify the ability of RICs to be structure to meet shareholder needs by permitting flow through of tax-exempt interest and foreign tax credits in a "fund-of-funds" structure.

We respectfully request that you consider these proposals as part of your comprehensive review of the US income tax system.

Simplify Tax Reporting to RIC Shareholders by Permitting Electronic Delivery of All Tax Information Returns and Subchapter M Designation Notices

The delivery of tax information to investors would be simplified if all required tax information returns could be delivered electronically. While the Job Creation and Worker Assistance Act of 2002 (the "Act") expanded significantly the number of information returns eligible for electronic delivery, including Forms 1099-DIV, it failed to include certain forms (e.g., Form 1042-S3 and Form 24394) that currently are mailed to investors.5 It also failed to eliminate the statutory mailing requirements for dividend designation notices to shareholders under Subchapter M.6 The rationale for permitting electronic delivery of IRS Forms 1099, including improved efficiency and modernization of the tax system, applies equally to electronic delivery of other tax information returns and required shareholder notices under Subchapter M.7 Accordingly, we recommend that electronic delivery be extended to cover all tax information returns and Subchapter M designation notices sent to RIC shareholders.

Simplify the Passive Foreign Investment Company (PFIC) Rules by Eliminating Application of the PFIC Asset Test to Portfolio Investors, Including RICs

Simplification of the passive foreign investment company (PFIC) rules—a process that began in 19978—should be extended through the repeal of the so-called passive asset test9 that is used by portfolio investors in foreign corporations (along with the passive income test10) to determine PFIC status. The passive asset test is very cumbersome for RICs (and other portfolio investors in a foreign corporation) to apply for two primary reasons. First, portfolio investors typically must test each foreign equity in their portfolio for PFIC status under the passive asset test, without regard to whether the foreign corporation is engaged in an active trade or business. Second, portfolio investors typically cannot obtain (or have great difficulty obtaining) the quarterly financial information necessary for application for the passive asset test, including information about intangible assets held by the foreign corporation.11 As a result, a remarkably disproportionate and costly effort is required to determine the PFIC status of portfolio equity holdings under the passive asset test.

Importantly, the passive income test for PFIC status is a far better measure of the extent to which US persons are avoiding the economic equivalent of current taxation by investing in foreign corporations.12 The mere holding of a passive asset by a US corporation, including a RIC, would not generate currently taxable income to investors. This same principle should be applied to determine the currently taxable income of US persons investing in foreign corporations under the PFIC rules. In general, the level of a foreign corporation's passive assets should not be relevant under the PFIC rules, except to the extent that the assets either generate current passive income to the corporation or reflect the accumulations of current passive income within a lower-tier corporation. Moreover, in contrast to the passive asset test, the passive income test for PFIC status relies on information that typically would be included in a foreign corporation's financial statements. Thus, the passive income test is both a more appropriate test for PFIC status and far more administrable than the passive asset test.[13]

Simplify the Ability of RICs to be Structured to Meet Shareholder Needs by Permitting Flow-Through Treatment of Tax-Exempt Interest and Foreign Tax Credits in a "Fund-of-Funds" Structure

In recent years, mutual fund complexes have been creating so-called "fund-of-funds" both to assist fund investors in acquiring a broader range of asset class exposure and as an asset allocation service. The fund-of-funds structure typically consists of one upper-tier fund and number of other (lower-tier) funds in which the upper-tier fund (as well as other investors) acquires shares. For example, a fund-of-funds might be created for investors seeking to retire in a particular year (e.g., 2020); the upper-tier fund would invest in lower-tier funds in a ways such that the overall investment risk of the upper-tier fund would become more conservative as the target date approached. One objective of the fund-of-funds structure is to put the upper-tier fund shareholder in essentially the same position the investor would be in had he or she invested directly in each of the underlying lower-tier funds (rather than indirectly in these funds through the upper-tier fund).

The taxation of shareholders in a fund-of-funds structure would be simplified if the upper-tier fund effectively were disregarded for purposes of the minimum asset percentage tests of Subchapter M, which were adopted before the fund-of-funds structure was created. These provisions require that (1) at least 50 percent of a RIC's assets consist of tax-exempt obligations for the RIC to be able to pay exempt-interest dividends to shareholders[14] and (2) more than 50 percent of a RIC's assets consist of foreign securities for the RIC to be able to pass through foreign tax credits to shareholders.[15] Mutual fund shareholders who invest indirectly in a lower-tier fund that distributes exempt-interest dividends or dividends eligible for foreign tax credit flow-through should not lose the favorable tax character of these distributions, as they do today, simply because the upper-tier fund does not independently meet the minimum asset percentage test. Moreover, adoption of this proposal would be consistent with the shareholders' understanding that their upper-tier fund investments are being allocated to the lower-tier funds.

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The Institute appreciates your consideration of these proposals. If we can provide you with any additional information, or respond to any questions you may have, regarding these proposals, please do not hesitate to contact me, at 202/326-5832, or Deanna Flores, Institute Associate Counsel, at 202/371-5436. Thank you.

Sincerely,

Keith Lawson
Senior Counsel

cc: Tricia Brown
Michael J. Cabellero
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ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,984 open-end investment companies ("mutual funds"), 504 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.925 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders.

2 March 22, 2002 letter from Keith Lawson to Robert P. Hanson and William F. Sweetnam, Jr.

3 Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding.

4 Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains.

5 The Secretary had the authority, prior to enactment of the 2002 Act, to issue rules under which Forms 5498 and the Forms 1099 related to Archer MSAs, IRAs, or Coverdell education savings accounts may be provided electronically. See Staff of Joint Comm. on Taxation, Technical Explanation of the "Job Creation and Worker Assistance Act of 2002," p. 27 (Comm. Print 2002).

6 See section 852(b)(3) (long-term capital gain dividends); section 852(b)(5) (exempt-interest dividends); section 853 (foreign tax credit flow-through); and section 854(b)(2) (dividends received deduction).

7 Under the Act, a recipient must consent to electronic delivery of a covered tax information return in a manner similar to the one permitted for electronic delivery of IRS Form W-2 (under Temp. Treas. Reg. sec. 31.6051-1T(j)) or in such other manner as provided by the Secretary.

8 The enactment of section1297(e) in 1997 eliminated the overlap between the controlled foreign corporation (CFC) rules and PFIC rules for US persons with a 10 percent or greater voting interest in a CFC. This simplification initiative essentially limited application of the PFIC rules to minority or portfolio investors.

9 Under the passive asset test of section 1297(a)(2), US investors are required to determine whether 50 percent or more of a foreign corporation's assets (on average) produce or are held to produce passive income.

10 Under the passive income test of section 1297(a)(1), a foreign corporation will be a PFIC if 75 percent or more of its gross income for the taxable year is passive.

11 Certain intangible assets of a foreign corporation may not be reported as balance sheet items or have been previously valued (e.g., self-generated goodwill or intangible assets not yet reduced to an income stream).

12 See, e.g., Statement of O. Donaldson Chapoton, Deputy Assistant Secretary for Tax Policy, Before the Senate Finance Subcomm. on Taxation and Debt Management (S. 1350), July 22, 1987.

13 We also would support an exemption from the passive asset test for portfolio investors, as opposed to its complete repeal. Such an approach could prevent any significant shareholders that were not subject to the CFC rules from avoiding application of the passive income test by "stuffing" passive income generating activities into non-consolidated (i.e., less than 25 percent-owned) subsidiaries. See Sections 1297(c) (PFIC subsidiary look-through rules) and 1298(a)(2) (PFIC attribution rules).

14 Section 852(b)(5).

15 Section 853.
