INVESTMENT COMPANY INSTITUTE

The Asset Management Industry SERVING INDIVIDUAL INVESTORS

COMMENT LETTER

September 5, 2002

Comment Letter on Proposed Transaction Disclosure for Registered Investment Companies, September 2002

By Hand and Electronic Delivery

September 5, 2002

Eric Solomon
Deputy Assistant Secretary for Regulatory Affairs
United States Department of the Treasury
1318 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Re: Enforcement Proposals for Abusive Tax Avoidance Transactions

Dear Mr. Solomon:

The Investment Company Institute[1] supports the Treasury Department's initiatives to broaden and align the rules and regulations for disclosure, registration and list keeping of abusive tax avoidance transactions under sections 6011, 6111 and 6112.[2] The Institute has determined, however, that the expanded definition of a "reportable transaction," as proposed under these initiatives, may place undue disclosure burdens on regulated investment companies ("RICs") engaged in routine portfolio transactions on behalf of their shareholders. Thus, we respectfully request that you consider adopting specific disclosure rules for RICs, as described below.

For purposes of disclosure by taxpayers, registration by promoters and maintenance of investor lists by promoters, the Treasury Department has proposed that a reportable tax avoidance transaction be defined as a transaction (including a series of related transactions) falling into any of the following categories:

1. Listed Transactions—Any transaction specifically identified by the IRS in published guidance as a tax avoidance transaction without regard to the size of the tax savings;[3]

2. Loss Transactions—Any transaction resulting in, or that is expected to result in, certain specified losses under section 165. For corporate taxpayers, the loss threshold would be \$10 million in any single year or \$20 million in any combination of years. For individual

taxpayers, the loss threshold would be $2 million in any single year or $4 million in any combination of years;

3. Transactions with Brief Asset Holding Periods—Any transaction resulting in a tax credit (including a foreign tax credit) in excess of $250,000 if the underlying asset giving rise to the credit was held by the taxpayer for less than 45 days;

4. Significant Book-Tax Differences—Any book-tax difference of at least $10 million, subject to specific exceptions for book-tax differences that are not indicative of potentially abusive tax avoidance practices; or

5. Transactions Marketed under Conditions of Confidentiality and that Provide Minimum Tax Benefits ("Confidential Transactions")—Any transaction promoted under conditions of confidentiality, if the transaction results in, or is expected to result in a specified reduction in taxable income.

As applied to a RIC, the categories for (1) loss transactions, (2) transactions with brief asset holding periods, and (3) transactions with significant book-tax differences potentially could require disclosure by the RIC of its routine, non-tax motivated portfolio transactions.[4] For example, cash purchases and sales of portfolio securities by a RIC at a loss of at least $10 million apparently would fall within the first category, even though the loss for the average fund shareholder would be quite small.[5] With respect to the second category, a RIC potentially could be required to disclose foreign tax credits realized by the RIC with respect to foreign tax withheld on dividends from foreign portfolio equities.[6] While RIC-specific rules could give rise to significant book-tax differences under the third category, we would expect such differences to be "carved out" as not indicative of potentially abusive tax avoidance practices.[7] Like other corporations, however, RICs could experience book-tax differences on routine portfolio transactions involving, for example, wash sales under section 1091 or section 1256 contracts.

We understand that imposing this disclosure burden on RICs might be warranted if necessary to achieve the objectives of the expanded disclosure regime for tax avoidance transactions. However, requiring such disclosure from RICs is not necessary for four reasons.

First, the extensive regulatory regime to which RICs are subject strictly limits their utility as tax avoidance vehicles. For example, the Securities and Exchange Commission ("SEC") regulates the operation of a RIC. In addition to a requirement to register with the SEC,[8] a RIC is subject under the 1940 Act to, for example, (1) requirements concerning the composition of its board of directors, including requirements that no more than 60 percent of the directors be "interested persons" of the RIC,[9] (2) limitations on the RIC's ability to borrow money or otherwise to issue "senior securities" (e.g., debt or equity securities with a dividend or liquidation preference),[10] (3) limitations on transactions between the RIC and its "affiliated persons" (and their "affiliated persons"),[11] (4) requirements concerning the custody of the RIC's assets[12], and (5) provisions governing the terms of the RIC's contracts with its investment advisers and principal underwriters.[13]

Second, the income and excise tax regimes to which RICs are subject effectively preclude tax avoidance (or deferral) by investors. Under these rules, a RIC typically distributes all of its income and capital gains to shareholders as taxable dividends on a current basis to avoid an entity-level tax under section 852(b) and the calendar-year excise tax imposed by section 4982.[14] Moreover, a RIC cannot pass through losses to shareholders[15] or specially allocate its portfolio earnings and net capital gains to particular shareholders.[16] Finally, the character of certain types of income earned by RICs, most notably short-term capital gains, is converted into an ordinary income dividend upon distribution to shareholders.[17]

Third, unlike the shares of other domestic corporations, the market value of a RIC's shares is not affected by tax attributes of the RIC. Shares in open-end RICs (i.e., mutual funds) are bought and sold at "net asset value." A RIC determines the net asset value for its shares by (1) computing the value of its portfolio investments, (2) subtracting accrued expenses and other liabilities, and (3) dividing the resulting net assets by the number of its outstanding shares. The presence (or absence) of tax attributes that may be generated by a "reportable transaction" does not affect this calculation.

Fourth, as a practical matter, investors cannot engage in abusive "tax planning" strategies through a RIC. The ability of a RIC to concentrate investments with respect to any private issuer is limited by the asset diversification requirements of section 851(b)(3).[18] In addition, investors ordinarily do not participate in the day-to-day management of a RIC and would not have advance knowledge about any particular transactions that may occur at the RIC level.[19] Moreover, to the extent a "reportable transaction" did occur at the RIC level, any potential tax benefit from that transaction could not be guaranteed to a particular investor due to a number of variables, including (1) changing market conditions and their impact on the RIC's investment decisions, (2) the timing and character of RIC distributions, and (3) in the case of an open-end RIC, the increase or decrease in the number of shares outstanding.

Finally, we note that RIC "master-feeder" structures would be affected by the Treasury Department's proposals to extend disclosure obligations for "reportable transactions" to non-corporate entities, including partnerships.[20] In a master-feeder structure, a domestic partnership typically holds portfolio assets on behalf of separate RIC partners or "feeder funds." The RIC feeder funds, in turn, typically are offered to investors. In this case, the reporting thresholds for the above disclosure categories likely would be satisfied at the master-fund level. In light of our above proposal, we recommend that where all (or substantially all)[21] the partners of a master-feeder structure are RICs, the master-fund partnership be exempted from disclosure obligations for (1) loss transactions, (2) transactions with brief asset holding periods, and (3) transactions with significant book-tax differences. We further recommend that disclosure exemptions from these same categories be provided for the master-fund partnership, to the extent that less than substantially all of its assets are allocated to RIC partners.[22] Where a master-fund partnership engages in listed transactions or Confidential Transactions, however, the Institute supports disclosure obligations for the master-fund partnership and each RIC partner under the Treasury Department's proposals.

For the foregoing reasons, we request that the Treasury Department provide an exception for RICs from the disclosure obligations for (1) loss transactions, (2) transactions with brief asset holding periods, and (3) transactions with significant book-tax differences. We further request that the Treasury Department provide an exception from these same disclosure obligations for domestic master-fund partnerships where all (or substantially all) the partners of the master fund are RICs or to the extent that less than substantially all of the assets of the master-fund partnership are allocated to RIC partners.

* * *

If the Institute can provide you with additional information regarding the suggestions made in this letter, please do not hesitate to contact the undersigned at 202/371-5436 or Keith Lawson, the Institute's Senior Counsel, at 202/326-5832. Thank you.

Sincerely,

Deanna Flores
Associate Counsel

cc (by e-delivery): Helen Hubbard
Jeffrey H. Paravano
Michael S. Novey
Jodi B. Cohen
Julian Kim
Lon B. Smith
Cary D. Pugh
Dale S. Collinson

ENDNOTES

1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 9,040 open-end investment companies ("mutual funds"), 484 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.906 trillion, accounting for approximately 95 percent of total industry assets and over 88.6 million individual shareholders.

2 All section references are to the Internal Revenue Code of 1986, as amended, and to regulations promulgated thereunder.

3 On June 14, 2002, the Treasury Department issued temporary and proposed regulations under sections 6011 and 6111 defining "reportable transactions" to include "listed transactions," regardless of their projected tax effect. The regulations also extend the disclosure obligation for "listed transactions" to individuals, trusts, partnerships and S corporations. See T.D. 9000.

4 Mindful of the policy underlying the Treasury Department proposals, we do not recommend carve-outs for RICs from the listed transactions or Confidential Transactions disclosure categories.

5 For example, a RIC with 500 individual investors (owning the same number of shares) would need to have a $1 billion loss at the RIC level before any shareholder would incur a $2 million loss on his or her RIC shares from the portfolio transaction.

6 A RIC realizing foreign tax credits on its portfolio may deduct the foreign tax at the RIC level or, if more than 50 percent of the RIC's portfolio consisted of foreign securities, elect to "pass through" the credits to shareholders under section 853. Most other business credits are not relevant for a RIC under Subchapter M.

7 Such RIC-specific book-tax differences could include transactions giving rise to "post-October" losses under Treas. Reg. § 1.852-11, for example.

8 Section 7(a) of the Investment Company Act of 1940 (the "1940 Act").

9 1940 Act, section 10.

10 1940 Act, section 18(f). Recent rule amendments require that, as a condition to relying on certain key exemptive rules under the 1940 Act, a majority of a RIC's directors must not be "interested persons" of the RIC.

11 1940 Act, sections 17(a), 17(d), 17(e) and 21(b).

12 1940 Act, section 17(f).

13 1940 Act, section 15.

14 RICs are allowed a dividends paid deduction for purposes of both the entity-level income tax under section 852(b)(1) and the entity-level excise tax under section 4982.

15 RICs may utilize capital losses to offset portfolio gains for up to eight taxable years succeeding the loss year. See section 1212(a)(1)(C)(i).

16 See section 562(c).

17 See section 852.

18 Similar rules apply to "diversified" investment management companies, including RICs, under section 5(b)(1) of the 1940 Act.

19 To the extent that the Treasury Department were concerned about "advance" transactional information being made available to investors in a closely-held RIC, any reporting carve-outs could be limited to RICs that were offered to the public. Even in this case, however, we would not expect a RIC to be used as a tax avoidance vehicle given (1) the regulation of all RICs by the SEC, as described above, (2) the inability of a RIC to pass through losses or short-term capital gains to investors, and (3) the inability of a RIC, irrespective of the number of its investors, to guarantee any particular tax benefit to any particular investor.

20 In T.D. 9000, as described above, the Treasury Department issued temporary and proposed regulations extending disclosure obligations for listed transactions, including transactions that are substantially similar to an identified transaction, to individuals, trusts, partnerships and S corporations.

21 A master-feeder structure initially may be established with one RIC feeder fund and one other partner that holds a nominal partnership interest (typically a management company or other entity establishing the structure). This permits the master partnership to qualify as such (i.e., by having two partners), until other RIC feeders are added. In certain cases, this nominal interest may be retained by the initial organizing partner.

22 For example, if 70 percent of a master-fund partnership's assets were allocated to RIC partners, those assets would not be included in a determination of whether the partnership exceeded the $10 million threshold for reporting loss transactions.

should not be considered a substitute for, legal advice.