The Asset Management Industry
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COMMENT LETTER

June 4, 2015

ICI Letter to IRS on Adviser Contributions to Money Market Funds (pdf)

By Electronic Delivery June 4, 2015 Hon. William Wilkins Chief Counsel Internal Revenue Service 1111 Constitution Avenue, NW Washington, DC 20224 RE: Money Market Fund Reform – Adviser Contributions Dear Mr. Wilkins: The Investment Company Institute,1 on behalf of its members, seeks additional guidance in relation to the pending implementation of the Securities and Exchange Commission ("SEC") money market fund rule2 (the "SEC Rule") adopted last summer. The requested guidance is necessary to, among other things, prevent redemptions from money market funds as they are required to transition from a stable net asset value ("NAV") fund to a floating NAV fund. As mentioned in our earlier submission3 and discussed below, we understand that some investment advisers may decide to make contributions of cash to existing money market funds to bring the shadow NAV of a fund up to $1.0000 before the compliance date for the SEC 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 by the fund is uncertain. Existing authorities suggest two possible approaches for analyzing these payments. As discussed below, however, neither approach fully resolves the issues raised by a contribution for this purpose. The first possible approach would treat the contribution as short-term capital gain.4 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 either distribute to its shareholders or retain and be subject to corporate-level tax. The amount of the distribution or tax paid would 1 The Investment Company Institute (ICI) is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $18.1 trillion and serve more than 90 million U.S. shareholders. 2 Money Market Fund Reform; Amendments to Form PF, SEC Release No. IC-31166 (July 23, 2014). 3 See Institute Letter to Michael Novey and Steven Harrison, dated March 11, 2015. 4 See Rev. Proc. 2009-10. ICI Letter June 4, 2015 Page 2 of 5 reduce the NAV to below the intended $1.0000 level. This result largely would negate the purpose of the contribution The second possible approach would treat the payment as a non-shareholder contribution. Although the payment would not result in immediate gain or income to the fund under section 118, 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).5 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, negating the purpose of the original contribution.6 As neither of these approaches would allow all of the contributed amount to remain in the fund, which is essential to ensure that the NAV is $1.0000 on the compliance date for the SEC Rule, guidance allowing a third alternative is necessary. Specifically, it is critical that such contributions remain in the fund's NAV, not creating income or gain to the fund or causing a reduction in the basis of the fund's assets. We thus ask the Internal Revenue Service ("IRS") to issue a revenue procedure, pursuant to which the IRS will not challenge a regulated investment company's ("RIC's") treatment of a contribution of cash from an investment adviser as resulting in (1) no capital gain or income to the fund, and (2) no reduction in the basis of the RIC's assets under section 362(c) of the Internal Revenue Code. To avoid any unintended consequences, we suggest that the requested revenue procedure be limited to (i) money market funds that comply with SEC Rule 2a-7, and (ii) contributions made prior to the compliance date for the floating NAV SEC Rule (October 16, 2016). Background Need for Adviser Contributions Prior to the compliance date for the new SEC Rule, money market funds have sought to maintain a stable NAV of $1.00, pursuant to SEC Rule 2a-7. Funds that meet Rule 2a-7's risk- limiting conditions have been permitted to value their securities using amortized cost accounting and/or penny rounding (that is, rounding their NAV to the nearest one percent or one penny, in the case of a money market fund with a stable NAV of $1.00). Thus, the market value of the assets in a money market fund's portfolio could be worth as little as $0.995 per share without impacting the fund's NAV of $1.00. If the value of the assets were less than $0.995 per share, 5 The regulations provide that the reduction of basis is made first to (a) property deemed to be acquired with the contributed money, if the acquisition of such was the purpose motivating the contribution; any excess is then applied to (b) the basis of other properties held by the corporation on the last day of the 12-month period beginning on the day the contribution is received. Treas. Reg. 1.362-2. Because the contribution to the fund will not be motivated by the purchase of specific property, clause (b) should apply. 6 We understand that some advisers or their affiliates have provided sponsor support to their money market funds in the past for various reasons. If these contributions were treated as non-shareholder contributions subject to section 362(c), the funds would have recognized capital gain in the next year when the affected assets were later sold. The funds thus may have required additional adviser contributions in that year to prevent a decrease in the NAV. This cycle will continue in each subsequent year and become a recurring problem that cannot be resolved without some action by the IRS. ICI Letter June 4, 2015 Page 3 of 5 the fund would have a NAV equal to $0.99 and would "break the buck." Pursuant to the SEC Rule, all money market funds must begin to disclose this "shadow NAV," out to four decimal places, to their shareholders beginning on April 14, 2016.7 Many money market funds already are disclosing the shadow NAV on a voluntary basis. Beginning on October 16, 2016, prime institutional money market funds (including institutional municipal money market funds) must maintain a floating NAV for sales and redemptions, based on the current market value of the securities in their portfolios, rounded to the nearest fourth decimal place (e.g., $1.0000).8 As a result, the daily share prices of the money market funds will fluctuate along with changes in the market-based value of the funds' investments. Thus, the NAV for these funds no longer will remain stable at $1.00. Transitioning from a stable NAV to a floating NAV presents a number of non-tax challenges. One substantial concern is that shareholders will leave the fund prior to the transition date. As noted above, money market funds will be required to disclose the shadow NAV in early 2016, if they are not doing so already. Thus, shareholders will know the mark-to-market value of a fund's portfolio. If a fund has a shadow NAV of less than $1.0000, investors may be inclined to sell their shares before the

transition to avoid experiencing a decline in share value once the NAV begins to float. In other words, if the shadow NAV of the fund is less than $1.0000, investors may choose to sell their shares at $1.00 while the NAV remains stable, rather than wait and experience a loss once the shares begin to trade at their four decimal place-NAV. This could cause a run on institutional money market funds, which is the very situation the floating NAV is intended to prevent. To prevent such behavior, we understand that some money market fund investment advisers may make cash contributions to their funds, to bring the shadow NAV up to $1.0000. This would allow the fund to begin with a floating NAV of $1.0000, rather than something less. These contributions may be made for other reasons as well.9 As the date for compliance with the new SEC Rule approaches, we anticipate that more firms will consider adviser contributions. We note that the SEC already has recognized the need for such contributions. In its recently released Frequently Asked Questions, the SEC provides that an adviser contribution made as part of a one-time reorganization, intended to bring a fund 7 Money market funds must disclose on their website the daily mark-to-market NAV, out to four decimal places, for the prior six months (i.e., beginning October 14, 2015). 8 Retail and government money market funds (as defined in the SEC Rule) are permitted to maintain a stable NAV. 9 For example, in order to better comply with the new SEC rule, two institutional money market funds may merge into one fund. If one of the merging funds has a shadow NAV of less than $1.0000 (or less than the NAV of the other fund), the adviser may wish to raise the NAV prior to the merger to place the two funds on equal footing. Alternatively, an institutional prime fund may convert into a government fund. Again, if the prime fund has a shadow NAV of less than $1.0000, the adviser may wish to raise the NAV prior to the conversion. A third scenario may arise if a government money market fund previously converted from a prime fund. The shadow NAV may be less than $1.0000 due to embedded losses that arose from securities held prior to such conversion. In this scenario, the shadow NAV deviation from $1.0000 has no bearing on the fund's current portfolio. Because all money market funds must disclose their shadow NAVs out to four decimal places beginning in April, 2016, the fund's adviser may determine that it should increase the NAV to prevent unwarranted concerns about the riskiness of its current assets. ICI Letter June 4, 2015 Page 4 of 5 into compliance with the SEC Rule, is not financial support that must be reported on Form N- CR.10 Rev. Proc. 2009-10 The 2009 IRS guidance on the treatment of adviser contributions addressed the problem then at hand. Recognizing the need for stabilizing actions after the 2008 financial crisis, the IRS issued Rev. Proc. 2009-10, indicating that it would not challenge the treatment of money market fund adviser cash payments as short-term capital gain in the taxable year in which the amounts were received. The guidance was limited to payments received before January 1, 2010. This approach succeeded because, in 2008 and 2009, money market funds had sufficient current losses to offset the short-term capital gain resulting from the treatment of the contributions. The 2009 solution will not work today because the purpose of the cash contributions is different. Advisers would contribute cash not because of current losses, but because of miscellaneous events that have taken place over several years that will cause a fund's four- decimal place shadow NAV to be less than $1.0000. We understand that some funds have historical deficits that have existed for years, and/or expired losses that created this decrease in value. Guidance Requested The mutual fund industry is working diligently to prepare for compliance with the new SEC Rule. As such, it is considering all options to ensure that the transition goes as smoothly as possible for both shareholders and funds. This type of adviser contribution is one mechanism that can assist in accomplishing this result. We thus ask the IRS to issue a revenue procedure that provides a safe harbor for the treatment of adviser contributions. Under this guidance, the IRS would not challenge a RIC's treatment of an adviser contribution as resulting in (1) no income or gain to the fund, and (2) no reduction in basis of the fund assets under section 362(c). The guidance could be

limited in scope to contributions made to funds that comply, or plan to comply, with Rule 2a-7, if such amounts are received prior to the compliance date for the SEC Rule (October 16, 2016). Given the short time-frame before funds must comply with the SEC Rule, we ask the IRS to issue such guidance expeditiously. We believe that such guidance would prevent runs on money market funds and help ease the transition to the new money market fund marketplace. * * * 10 The Frequently Asked Questions can be found on the SEC's website at:
http://www.sec.gov/divisions/investment/guidance/2014-money-market-fund-reform-frequently-asked- questions.shtml. See Question 3. ICI Letter June 4, 2015 Page 5 of 5 The Institute appreciates your consideration of this important issue. If I can assist you in any way, please do not hesitate to contact me at (202) 371-5432 or kgibian@ici.org. Sincerely, /s/ Karen L. Gibian Karen Lau Gibian Associate General Counsel – Tax Law cc: David Grim Securities and Exchange Commission Thomas West U.S. Department of Treasury Michael Novey U.S. Department of Treasury Erik Corwin Internal Revenue Service Helen Hubbard Internal Revenue Service Steven Harrison Internal Revenue Service

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