

COMMENT LETTER

June 30, 2011

ICI Letter to IRS and Treasury Requesting Guidance on the RIC Modernization Act of 2010 (pdf)

By Electronic Delivery June 30, 2011 Emily S. McMahon William J. Wilkins Deputy Assistant Secretary for Tax Policy Chief Counsel U.S. Department of the Treasury Internal Revenue Service 1500 Pennsylvania Avenue, NW 1111 Constitution Avenue NW Washington, DC 20220 Washington, DC 20224 RE: Request for Guidance Regarding the RIC Modernization Act of 2010 Dear Ms. McMahon and Mr. Wilkins: The Investment Company Institute¹ asks the Internal Revenue Service (“IRS”) and the Department of the Treasury to clarify certain issues related to implementation of the Regulated Investment Company (“RIC”) Modernization Act of 2010 (the “Act”). Specifically, the Institute requests that the IRS and Treasury Department issue guidance providing that: • The capital loss carryforward provision of the Act is effective for purposes of the calendar year 2011 excise tax calculation under section 4982 of the Internal Revenue Code of 1986, as amended (the “Code”); 2 • The “bifurcation” rules of Notice 97-64,³ as modified by Notice 2004-39,⁴ continue to apply to the extent necessary to prevent the recharacterization of capital gain dividends; and • RICs may satisfy the “written statement” requirements of the Act regarding the character of certain dividends by posting the information on their public websites. 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.41 trillion and serve over 90 million shareholders. 2 All section references hereinafter are to the Code, unless otherwise noted. 3 1997-2 C.B. 323. 4 2004-1 C.B. 982. ICI Letter re RIC Modernization Act June 30, 2011 Page 2 of 10 Capital Loss Carryforwards – Effective Date for Excise Tax Purposes Under prior law, RICs could carry forward capital losses for eight years. A RIC’s capital loss carryforwards were treated as short-term capital losses in the year to which they were carried without regard to whether the loss giving rise to the carryforward was long-term or short-term. Section 101 of the Act amended Code section 1212(a) to provide that RICs now may carry forward capital losses indefinitely. In addition, the long-term or short-term nature of the loss is preserved; the carryforward is treated as long-term or short-term depending on the character of the loss that gave rise to it. These changes “apply to net capital losses for taxable years beginning after the date of the enactment of this Act” (i.e., taxable years beginning after December 22, 2010).⁵ Determining the effective date of these changes for income tax purposes is simple. There is ambiguity, however, as to the effective date of these changes for purposes of the excise

tax imposed by section 4982. Under section 4982, a RIC is subject to an excise tax on a calendar-year basis, without regard to the taxable year of the RIC for income tax purposes. The tax is equal to 4% of the excess (if any) of the "required distribution" for the calendar year over the "distributed amount" for the calendar year. The required distribution is defined as the sum of (i) 98% of the RIC's ordinary income for the calendar year, and (ii) 98.2% of the RIC's capital gain net income for the one-year period ending October 31 of such calendar year. Typically, when legislation amends a provision relating to the excise tax regime under section 4982, the effective date is tied to the calendar year rather than to the taxable year of the RIC. For example, sections 401 through 404 of the Act contain amendments relating to section 4982. Each of these provisions is effective for "calendar years beginning after the date of the enactment of this Act" (i.e., the changes are effective for the calendar year 2011 excise tax calculation). It is unclear how the reference in section 101 of the Act to "taxable years" beginning after the date of enactment should be interpreted for excise tax purposes. There are three possibilities: (1) The new capital loss carryforward rules are effective for purposes of the 2011 excise tax calculations (the period for which begins on November 1, 2010, for purposes of measuring capital gain net income); (2) The new rules are effective for the 2012 excise tax calculations (the period for which begins on November 1, 2011, for purposes of measuring capital gain net income); or (3) The new rules are effective as of the first day of the RIC's first "regular" taxable year (the taxable year for income tax purposes) beginning after the date of enactment for both income tax and excise tax purposes. 5 See Act section 101(c). Section 101 also includes an ordering rule that requires RICs to utilize post-enactment carryforwards before pre-enactment carryforwards. This rule applies "to taxable years beginning after the date of the enactment of this Act." ICI Letter re RIC Modernization Act June 30, 2011 Page 3 of 10

Alternative 1 – Consistent with Other Act Provisions and Easy to Administer We urge Treasury and the IRS to issue guidance clarifying that the first of these three alternatives is correct. For excise tax purposes, the taxable year is the calendar year. Thus, as a technical matter, it is reasonable to view the calendar year as the "taxable year" for purposes of applying section 101 of the Act to Code section 4982. In addition, because all of the other provisions of the Act relating to the excise tax apply for calendar year 2011, it seems likely that Congress intended the amendments made by section 101 of the Act to have a similar effective date for excise tax purposes. We are not aware of any reason why Congress would have intended a different effective date for the capital loss carryforward changes as they relate to the excise tax than for the other excise-tax-related changes in the Act. Section 4982 applies on a calendar-year basis, even though the measurement period for capital gain net income begins two months earlier, on November 1. When it enacted section 4982 in 1986, Congress acknowledged that the "calendar year" effective date nevertheless had some retroactive effect by computing capital gain net income beginning November 1 of the prior calendar year. The Joint Committee on Taxation's explanation of the Tax Reform Act of 1986 states with respect to the newly enacted excise tax: Although the excise tax is imposed only for calendar years beginning after December 31, 1986, the computations that are necessary to determine whether any excise tax is due and the amount so due, will require certain calculations involving income, losses, and distributions with respect to periods before the first calendar year for which the excise tax is imposed. For example, the excise tax for the first calendar year beginning after December 31, 1986, generally must take into account capital gains and losses for the period beginning on November 1, 1986, and ending on October 31, 1987.⁶ Thus, Congress expected RICs to include capital gains and losses incurred before the effective date of the new section 4982, because such gains and losses fell within the proper measurement period. It is reasonable to apply similarly the provisions of section 101 of the Act to capital gains and losses arising on or after November 1, 2010.

Alternative 2 – Problems Created Suggest this Result was not Intended The second

alternative listed above, which would postpone the effective date for section 101 of the Act for excise tax purposes until the 2012 calendar year, would create exactly the type of problem that the Act was intended to resolve. Specifically, this effective date could cause a RIC to have an excise 6 Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (the "1986 Blue Book"), JCS-10-87, p. 379. ICI Letter re RIC Modernization Act June 30, 2011 Page 4 of 10 tax distribution requirement without the earnings and profits necessary to make the required distribution. Thus, it seems unlikely that Congress intended this result. The theory for the second alternative would be that the "taxable year" for the capital loss carryforward provision for excise tax purposes begins on the date that a RIC begins measuring capital gains and losses for determining its excise tax "required distribution."⁷ Thus, the first post-enactment "taxable year" would begin on November 1, 2011, and the provision would apply to distributions made for calendar year 2012. As a result, the vast majority of RICs would have the new capital loss carryover rules apply for income tax purposes before (and often well before) they apply for excise tax purposes. Congress could not have intended this result. It means that a RIC could have a capital loss carryover that expires for excise tax purposes but does not expire for income tax purposes. In this event, the RIC would have an excise tax distribution requirement but would lack the earnings and profits needed to make the required distribution. Example: A calendar-year RIC has a \$1,000 net capital loss for 2011. This loss is governed by the new rules and can be carried forward indefinitely for income tax purposes. Assume the RIC similarly has a \$1,000 net capital loss for the one-year period ending October 31, 2011, as computed for excise tax purposes.⁸ Under the second alternative interpretation, this loss can be carried forward for eight years and then it will expire. Now assume that the RIC has capital gain of \$1,000 in 2020 and that it similarly has \$1,000 of gain for the one-year period ending October 31, 2020, for excise tax purposes. Also assume that the RIC has not used the 2011 capital loss carryforwards during the intervening years. For income tax purposes, the \$1,000 loss is carried forward to offset the \$1,000 gain, and the RIC will have no income in 2020 and no earnings and profits.⁹ For excise tax purposes, however, the 2011 capital loss carryforward has expired, and the RIC thus has to make a \$982 dividend distribution to avoid the excise tax. Because the RIC has no earnings and profits, however, it cannot make a dividend distribution. Even if it were to distribute \$982, it still would be subject to the excise tax for 2020. In addition, because each year's excise tax distribution requirement is cumulative (i.e., it takes into account any underdistribution ⁷ See section 4982(e)(2)(A). The Joint Committee on Taxation staff's Blue Book on the Tax Reform Act of 1986 states that Congress understood that for purposes of computing a RIC's capital gain net income, the one-year period ending October 31 "would be treated as the [RIC's] taxable year for purposes of the capital loss carryover provisions and for purposes of the year-end straddle and mark-to-market rules." See 1986 Blue Book, p. 378, n. 7. ⁸ For example, the RIC might have no capital gains and losses in November or December of 2010, and \$1,000 net capital loss for January through October of 2011. ⁹ Under section 302 of the Act, the capital loss carried forward to 2020 will reduce earnings and profits for the 2020 taxable year. ICI Letter re RIC Modernization Act June 30, 2011 Page 5 of 10 in prior years), the distribution shortfall would continue to give rise to excise tax liability in future years. The Act was designed to modernize the RIC tax rules and eliminate exactly this kind of problem.

Alternative 3 – More Complex Route to a Workable Solution The third alternative interpretation is that section 101 of the Act is effective for excise tax purposes as of the first day of a RIC's first "regular" taxable year beginning after the date of enactment. Under this interpretation, RICs with taxable years beginning between January 1 and October 1 of 2011 would bifurcate the one-year period ending October 31, 2011. The first portion of that one-year period (ending on the last day of the RIC's taxable year ending in 2011) would be governed by prior law and the second portion (beginning on the first day of the RIC's

taxable year beginning in 2011) would be subject to the new rules. For example, a RIC with a net capital loss for the excise tax 12-month period ending October 31, 2011, and a taxable year that ends on June 30, would bifurcate 2011 into two periods for excise tax purposes. The portion, if any, of the net capital loss attributable to the period between November 1, 2010, and June 30, 2011, would be subject to prior law. The remainder of the net capital losses (attributable to the period between July 1, 2011, and October 31, 2011) would be governed by the Act.¹⁰ There also is support for this bifurcated approach. When section 4982 was added to the Code as part of the Tax Reform Act of 1986 (the "1986 Act"), there was uncertainty about the effective date for excise tax purposes of other provisions included in the 1986 Act that were effective with reference to the taxable year of the taxpayer. In Notice 88-4,¹¹ the IRS addressed whether the applicability of those provisions should be based upon the excise tax year or a RIC's "regular" taxable year. The Notice states: [T]he treatment of a RIC as having a calendar year or a year ending October 31 as its taxable year for purposes of section 4982 will not apply for the purpose of determining the applicability of provisions the effective date of which is determined with reference to the taxable year of the taxpayer. Rather, the actual taxable year of the RIC will be used to determine the applicability of such provisions. The Notice then provides an example illustrating the application of the section 988 foreign currency rules to RICs for excise tax purposes. ¹⁰ RICs with taxable years beginning on November 1 or December 1 would not bifurcate any part of the period ending October 31, 2011, for excise tax purposes. RICs with taxable years beginning on November 1 would apply the new rules of the Act to the period beginning November 1, 2011, for both income and excise tax purposes. RICs with taxable years beginning on December 1 would bifurcate the one-year period ending October 31, 2012, with the first month of that period governed by the old rules and the remaining 11 months governed by the new rules. ¹¹ 1988-1 C.B. 474. ICI Letter re RIC Modernization Act June 30, 2011 Page 6 of 10 The bifurcated approach avoids the earnings and profits problem associated with a November 1, 2012, effective date, as described above, and thus is preferable to that alternative. If Treasury and the IRS decide that the Notice 88-4 approach is sensible here, we ask that the guidance include operating rules addressing issues that would arise under this approach.¹² Institute's Proposal Although the bifurcated approach could be workable, the Institute and its members believe that the first interpretation described above, which would apply section 101 of the Act to the calculation of all calendar year 2011 distributions, is preferable and more consistent with Congressional intent. This first alternative is much simpler and could be applied consistently across all funds in a complex. Therefore, we ask the IRS and Treasury Department to issue guidance clarifying that the capital loss carryforward rules in the Act are effective for purposes of the excise tax calculation for calendar year 2011. It has been suggested that this issue need not be addressed until eight years from now, when the question of whether capital losses arising in the 2011 excise tax year are subject to expiration will be more squarely presented. RICs will need to track these losses on a current basis, however, and a RIC with a net long-term loss that exceeds its net short-term gains for the 2011 excise tax year will need to know if the loss carryforward to the 2012 excise tax year is a long-term loss (under the new rules) or a short-term loss (under the old rules). The long-term versus short-term distinction is important under section 4982 because a RIC's capital gain net income is reduced by an ordinary loss but not below the amount of the RIC's net capital gain.¹³ Therefore, we ask the IRS and Treasury Department to address this issue expeditiously. Bifurcation – Application of Notice 97-64 As discussed above, section 4982 requires a RIC to distribute by December 31 of each calendar year virtually all of its capital gain net income for the one-year period ending on October 31 of such year. In enacting section 4982, Congress recognized that certain rules were needed to coordinate this distribution requirement with the rules for computing a RIC's capital gains and losses

on a taxable year basis for income tax purposes. For example, prior to the amendments made by the Act, section 852(b)(3)(C) provided that for purposes of determining the amount a RIC may designate as a capital gain dividend for a taxable year, any net capital loss or net long-term capital loss attributable to the portion of the taxable year after October 31 is treated as arising on the first day of the next taxable year. 12 For example, if a RIC had a \$40 capital loss for the first part of the bifurcated transition year and a \$60 loss for the second part of the year, would the \$40 loss be treated as if were a separate loss carryforward governed by the old rules and the \$60 loss as a capital loss carryforward governed by the new rules? If the RIC has net gains in one period and net losses in the other, with an overall net capital loss for the one-year period, would the determination of whether the loss was under the old rules or the new rules depend on the period in which the net losses arose? Would gains and losses be netted across the two periods to determine whether the loss being carried forward is long-term or short-term? 13 See section 4982(e)(2)(B). ICI Letter re RIC Modernization Act June 30, 2011 Page 7 of 10 Treasury issued regulations under this provision allowing a RIC to elect to defer all or part of any such loss for taxable income purposes as well.14 These rules were needed to prevent post-October losses from changing the character of pre-November capital gains on a full taxable year basis. Absent this protection, a RIC's designation of capital gain dividends distributed in December might become incorrect as a result of a net capital loss or net long-term capital loss arising in the post-October 31 portion of its taxable year. In 1997, Congress created several different categories of long-term capital gains (e.g., 20% rate gain and 28% rate gain). This change meant that a RIC's designation of a capital gain dividend (as, say, 20% gain) might become incorrect on a full taxable year basis even if there was no net capital loss or net long-term capital loss after October 31 of the taxable year. In order to address this concern, the IRS issued Notice 97-64, which under certain circumstances requires a RIC to "bifurcate" its taxable year into pre-November and post-October periods for purposes of netting capital gains and losses. Specifically, Notice 97-64 requires a RIC to bifurcate its taxable year into pre-November and post-October periods if: • The RIC has a net capital gain for the pre-November portion of its taxable year, • The RIC does not use as its tax year the 12-month period for determining its capital gain net income for purposes of section 4982, and • The RIC is not required to defer a post-October loss under (now former) section 852(b)(3)(C). The Service subsequently issued Notice 2004-39, which modified certain aspects of the guidance under Notice 97-64 to reflect changes made by the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (JGTRRA). Although the bifurcation rules in Notices 97-64 and 2004-39 addressed the basic problems resulting from section 1(h), they did so in ways that created other issues. The Institute has raised these issues in comment letters to the IRS and Treasury Department over the years. The Act has now resolved many of these issues through its changes to the deferral rules for post-October losses, including changing the mandatory deferral of a post-October net capital loss or net long-term capital loss to elective deferral. There remain certain limited situations, however, in which RICs still need to apply the bifurcation approach of Notice 97-64 in order to preserve the character of pre-November capital gain. For example, bifurcation still is necessary when a RIC (i) has pre-November net capital gain, (ii) has a post-October loss in some long-term gain category (i.e., 15% or 28% rate gain) that could change the category of pre-November net capital gain on a taxable year basis, and (iii) does not have a post- 14 See Treas. Reg. § 1.852-11. ICI Letter re RIC Modernization Act June 30, 2011 Page 8 of 10 October net capital loss, net long-term loss, or net short-term loss that, if pushed, could be used to avoid reclassification of the net capital gain. For example, assume that a RIC has \$100 of 15% rate gain in the pre-November period. The RIC also has \$100 of 15% rate loss and \$100 of 28% rate gain for the post-October period. Without bifurcation, the RIC would have \$100 of 28% rate gain for the taxable year but would have distributed a \$100 capital

gain dividend in December and reported it as 15% rate gain. The changes made by the Act do not address this problem. Under Notice 97-64, the RIC would apply the bifurcation rules, resulting in \$100 of 15% capital gain for the taxable year. The changes made by the Act have a twofold impact on Notice 97-64. First, as explained above, they make the bifurcation adjustment unnecessary in many situations in which it was required under the Notice. Second, the operative language of the Notice, which references the prior law version of section 852(b)(3)(C), needs to be updated to reflect the changes made by the Act. For both of these reasons, the Institute asks the IRS and Treasury to issue guidance updating Notice 97-64 and clarifying that the bifurcation rules still are applicable when necessary to avoid reclassification of capital gains distributions reported by a RIC. This guidance also should make clear that the bifurcation approach does not apply in situations in which it is not needed.

Reporting Capital Gains and Other Dividends Under prior law, in order for a dividend paid by a RIC to be treated as a capital gain dividend, the RIC was required to designate the dividend as a capital gain dividend in a written notice mailed to its shareholders within 60 days after the close of the RIC's taxable year. A similar requirement applied with respect to other types of dividends, such as exempt-interest dividends, and with respect to certain credits that RICs are allowed to pass through to shareholders (such as foreign tax credits). RICs typically made the required designations in their annual reports, which are mailed to shareholders within the requisite 60-day period. Prior law raised concerns in the industry about situations in which, due to unforeseen circumstances, the annual reports were not actually mailed within sixty days of the end of a RIC's taxable year. The implementation of FASB's FIN 48 in 2007 increased the need for RICs to be able to resolve issues raised by inadvertent failures to meet the dividend designation requirements. This concern intensified after an IRS official made comments regarding the issue at the Institute's 2008 Tax and Accounting Conference. During one of the panels, an industry representative outlined a hypothetical situation in which a RIC's warehouse burns down fifty-nine days after the close of the RIC's taxable year, resulting in a loss of all of the printed annual reports. The question posed was whether the IRS could provide any relief to the RIC under those facts. The IRS official responded that the government could not provide any assistance to the RIC, because the statute clearly requires designation within a prescribed time period. Therefore, the RIC would be in violation of the dividend designation requirements.

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The Act addressed these issues by eliminating the requirement that a RIC designate dividends by mailing a written notice to shareholders within 60 days of the end of the RIC's taxable year. Section 852(b)(3) now provides that a capital gain dividend is "any dividend, or part thereof, which is reported by the company as a capital gain dividend in written statements furnished to its shareholders" (emphasis added). Similar rules apply to the other types of distributions to which the former designation requirement applied. Notably, the new rules do not require the information to be "mailed" to shareholders and do not include any requirement as to the time by which the information must be provided. This relaxation of the requirements of prior law was possible because relevant tax information about a RIC's distributions separately is required to be provided to the vast majority of RIC taxable shareholders through the Form 1099 reporting process. The Joint Committee on Taxation's explanation of the Act¹⁵ notes that "[a] written statement furnishing this information to a shareholder may be a Form 1099." Because not all shareholders receive Forms 1099, however, RICs must use some other means for reporting distributions to those shareholders who do not receive Form 1099, such as corporations, retirement plans, and tax-exempt entities. Given the different types of distributions that RICs must report and the different types of shareholders who may receive such distributions, however, it would be difficult to craft specific rules that cover every situation. Difficulties also would ensue in deciding which communication is the "furnished" statement, as this information often is reported to

shareholders in multiple formats (e.g., Forms 1099, quarterly and year-end statements). As mentioned above, RICs typically have designated capital gain and other dividends in their annual reports. RICs clearly are permitted under the Act to continue reporting these dividends in their annual reports.¹⁶ Nevertheless, many funds would like to find alternative methods for reporting dividends. As the IRS and Treasury Department are aware, the annual reports contain an abundance of information. The utility of continuing to report this information in the annual report thus is questionable. A logical alternative is a RIC's public website. Website reporting would provide easy and equal access to all shareholders who need information regarding a fund's distributions.¹⁷ The financial services industry today generally is moving away from printed and mailed materials and turning more often to electronic communications and disclosures. A fund's public website is an integral component of its contact with its shareholders. ¹⁵ Joint Committee on Taxation, General Explanation of the Tax Legislation Enacted in the 111th Congress, JCS-2-11, p. 672. ¹⁶ Much of this information already is included in the notes to the financial statements and should be sufficient for satisfying the "written statement" requirement. ¹⁷ The website could indicate that the information provided therein is the "official" written statement and that all other forms in which this information is communicated are not furnished written statements for this purpose. ICI Letter re RIC Modernization Act June 30, 2011 Page 10 of 10

The IRS and Treasury Department have recognized the utility of websites for other information reporting purposes. Specifically, in Notice 2011-34, which addresses the new Foreign Account Tax Compliance Act ("FATCA") provisions enacted in 2010,¹⁸ the IRS contemplates the use of website disclosure for passthru payment percentage information by participating foreign financial institutions (FFIs). The Institute thus asks the IRS and Treasury Department to provide guidance specifying that RICs that report capital gains and other dividends on their websites will be deemed to have satisfied the new reporting requirements of the Act. * * *

The Institute appreciates your attention to these issues, and we look forward to discussing them with you further. Please contact Keith Lawson (202-326-5832 or lawson@ici.org) or me (202-371- 5432 or kgibian@ici.org) if you have any questions or concerns, or if we can provide you with any additional information. Sincerely,

/s/ Karen L. Gibian Karen Lau Gibian Associate Counsel – Tax Law cc: Jeffrey Van Hove Karl Walli Michael S. Novey Stephen R. Larson Alice M. Bennett Susan T. Baker Richard LaFalce

¹⁸ The FATCA provisions were enacted as part of the Hiring Incentives to Restore Employment Act of 2010, Pub. L. 111- 147, which added a new chapter 4 (sections 1471 – 1474) to Subtitle A of the Internal Revenue Code.