

## COMMENT LETTER

May 20, 2010

# ICI Submits Comments to the IRS on Stripping Transactions for Qualified Tax Credit Bonds

By Electronic Delivery May 20, 2010 The Honorable Michael Mundaca The Honorable William Wilkins Assistant Secretary for Tax Policy Chief Counsel U.S. Department of Treasury Internal Revenue Service 1500 Pennsylvania Avenue NW 1111 Constitution Avenue NW Washington, DC 20220 Washington, DC 20224 RE: Comments on Notice 2010-28 – Stripping Transactions for Qualified Tax Credit Bonds Dear Mr. Mundaca and Mr. Wilkins: The Investment Company Institute<sup>1</sup> appreciates this opportunity to provide the Internal Revenue Service (the “IRS”) and the Treasury Department with our comments on Notice 2010-28, which describes regulations that the government expects to issue concerning stripping transactions for qualified tax credit bonds and certain income tax accounting matters associated with holding and stripping these bonds. Specifically, the Institute recommends that the IRS and Treasury Department expand the list of persons with whom a taxpayer may hold a stripped credit coupon, so that a regulated investment company (a “RIC”) clearly is allowed the tax credit when it holds a stripped credit coupon in an account with a custodian. The Institute also recommends that the IRS simplify the information reporting requirements for tax credit bonds and stripped tax credit coupons with respect to RICs and their shareholders. Allowance of the Tax Credit to a Holder of a Stripped Credit Coupon The interim guidance in Notice 2010-28, without further guidance from the IRS, appears effectively to preclude RICs from holding a stripped credit coupon. Section 3.03(d) of the Notice states that a taxpayer who holds a stripped credit coupon on a credit allowance date is allowed the tax credit only if all of the following requirements are satisfied: (1) The bond is part of a strippable issue within the meaning of the Notice; 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 \$11.94 trillion and serve almost 90 million shareholders. Investment Company Institute Letter re Notice 2010-28 May 20, 2010 Page 2 of 4 (2) The stripped credit coupon is either a whole credit coupon or a proportional share of a whole credit coupon; and (3) The taxpayer holds the stripped credit coupon in an account with (i) a broker as defined in section 6045(c)(1); or (ii) any other person to the extent provided by the Commissioner in published guidance. Under these rules, it is not clear whether a RIC that holds a stripped credit coupon in an account with a custodian would be permitted to take (or pass through to its shareholders) the tax credit. RICs will not hold these coupons without assurance that their shareholders will

benefit from the associated credit. Under the Investment Company Act of 1940 (the “1940 Act”), RICs can hold their assets internally, with a broker/dealer, or with a bank. The custody rules, like the 1940 Act’s other provisions, are intended to protect the RIC’s investors and therefore are particularly stringent. The broker/dealer rules have not been updated since the 1940s, however, and are largely unworkable today. The self-custody rules also are quite onerous and do not provide any additional shareholder protection. Therefore, virtually all RICs hold their assets with a bank custodian. These rules are more workable and protect the RIC’s shareholders more efficiently. The custodian’s services generally include safekeeping and accounting for the regulated fund’s assets, settling securities transactions, receiving dividends and interest, providing foreign exchange capabilities, paying fund expenses, reporting failed trades, reporting cash transactions, monitoring corporate actions and tracing loaned securities. The interim guidance contained in Notice 2010-28, however, may prevent any RIC that keeps its assets with a bank custodian from holding a stripped credit coupon unless the IRS issues additional guidance on the issue.<sup>2</sup> Custodian banks clearly are poised to provide the IRS with whatever information regarding stripped credit coupons held by RICs that the IRS may need to ensure tax compliance. The Institute thus recommends that the IRS issue guidance permitting RICs to take the tax credit if they hold a stripped credit coupon with a custodian. Information Reporting Requirements Related to Tax Credit Bonds Notice 2010-28 contemplates a rigorous information reporting system for tax credit bonds and stripped tax credit coupons. This expansive system, however, creates unnecessary burdens with respect to tax credits that are distributed by a RIC to its shareholders. A taxpayer who claims on its income tax return a tax credit under section 54A must include Form 8912 with the return. Section 4.03 of the Notice anticipates that this form will be modified to include not only the type of tax credit bond and the amount of credit claimed, but also the tax identification number of the issuer of the bond and the CUSIP number for the tax credit bond or the stripped credit coupon that is the basis for the credit being claimed. <sup>2</sup> It is not clear whether a bank that custodies assets for a RIC “stands ready to effect sales to be made by others” and therefore constitutes a broker for purposes of information reporting under section 6045. See Treas. Reg. § 1.6045-1(a)(1). Investment Company Institute Letter re Notice 2010-28 May 20, 2010 Page 3 of 4 The IRS also expects to publish a new form, Form 1097-BTC, to inform both the IRS and any recipient of a tax credit of the amount of the tax credit that the recipient has received for each credit allowance date. The government anticipates that this form will be filed on, or on behalf of, the issuer, and also will be required from each broker or intermediary that is not acting on behalf of the issuer (an “independent intermediary”). The requirement for independent intermediaries is expected to apply whenever such an intermediary serves as an agent or nominee with respect to a credit or the intermediary receives a credit and passes it on either to another independent intermediary or to the taxpayer that ultimately will claim the credit. The Notice lists examples of independent intermediaries, including RICs that distribute tax credits with respect to their stock under section 853A. The Notice anticipates that the information required on the Form 1097-BTC will include the amount of the credit transferred to the recipient, the bond issuer’s tax identification number, and the CUSIP number for the qualified tax credit bond or stripped credit coupon. Beginning in 2010, responsible persons under section 6049 would file the form with the IRS annually after the close of the calendar year and would include the total amount of tax credits for which the responsible persons served as such during the taxable year with respect to each independent intermediary and each holder of a tax credit bond or stripped credit coupon. Beginning in 2011, responsible persons under section 6049 would send the form to the credit recipient quarterly within 30 to 60 days following the credit allowance date to which the tax credit relates. Section 4.05(b) of the Notice expects that if a RIC receives tax credits (either because it holds a qualified tax credit bond or stripped

coupon or because it receives the credits from an independent intermediary) and distributes with respect to its stock some or all of those credits, then the RIC will be required to include any distributed tax credits that are treated as dividends on the Forms 1099-DIV that are sent to shareholders under section 6042.3 These rules, if implemented, would require a RIC to send to both the IRS and every shareholder a form or forms that separately list every tax credit bond or stripped coupon held by the RIC. Shareholders would receive these forms every quarter. Further, any tax credits distributed by a RIC to its shareholders will be reported annually on Form 1099-DIV. The Institute does not believe it is necessary for a RIC to report to its shareholders every tax credit bond or stripped coupon held by the RIC. RICs that invest in these securities can be expected to hold multiple tax credit bonds or stripped credit coupons in their portfolios, and these portfolios may change between credit allowance dates. Providing such detailed information to shareholders will be of little use and likely will result only in confusion to the shareholders. The Institute recommends instead that RICs report to each shareholder the amount of tax credits distributed to such shareholder on an aggregate basis, rather than a bond-by-bond (or coupon- 3 RICs that invest in tax-exempt bonds now are required to report any tax-exempt interest that is distributed to shareholders as exempt-interest dividends on the Form 1099-INT, rather than the Form 1099-DIV. Requiring RICs to report exempt- interest dividends on Form 1099-INT while reporting tax credits on Form 1099-DIV may result in significant confusion to shareholders. Investment Company Institute Letter re Notice 2010-28 May 20, 2010 Page 4 of 4 by-coupon) basis. This also would allow RICs to report such information to shareholders on a quarterly basis much more efficiently; requiring quarterly reporting that separately lists every tax credit bond or stripped credit coupon held by the RIC would require a significant increase in reporting with no discernable benefit to the shareholder. Under the Institute's proposal, the RIC would report to the IRS both the individual tax credit bonds and stripped credit coupons held by the RIC for the taxable year, as well as the aggregate amount of tax credits distributed to each shareholder. The anticipated reporting requirements outlined in the Notice suggest that the IRS and Treasury Department are concerned that tax credits be claimed only once. If a RIC reports to the IRS (i) every tax credit bond and stripped credit coupon it holds, (ii) the amount of tax credits attributable to each bond or coupon, and (iii) the aggregate amount of tax credits distributed to each shareholder, the IRS easily could confirm that the tax credits allowed to the RIC and distributed to its shareholders are reported accurately by the shareholders and do not exceed the credits attributable to the tax credit bonds and stripped credit coupons held by the RIC. The effect of the Institute's recommendations would be to streamline the reporting rules by reducing the volume of information that RICs must send to their shareholders if RICs distribute tax credits. RICs only would be required to report on Forms 1097-BTC sent to their shareholders, both quarterly and annually, the aggregate amount of tax credits distributed to each shareholder. RICs would report separately to the IRS, as required in the Notice, information on each tax credit bond or stripped credit coupon held by the RIC. RICs also would report to the IRS the aggregate amount of tax credits distributed to each shareholder. Our proposal would accomplish the IRS's goals while reducing the unnecessary quantity of information. \* \* \* Should you have any questions or concerns regarding the Institute's comments, we would be happy to discuss these issues with you further. Please contact Keith Lawson (202/326-5832 or lawson@ici.org) or me (202/371-5432 or kgibian@ici.org) if we can provide any additional information. Sincerely, /s/ Karen L. Gibian  
Karen Lau Gibian Associate Counsel – Tax Law cc: Joshua Odintz Michael Novey Stephen Larson Aviva Roth Timothy Jones

---

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.