

Congress Passes Tax Legislation Affecting Regulated Investment Companies

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The Regulated Investment Company Modernization Act of 2010 (the "Act") was passed by Congress on December 15, 2010 and sent to President Obama for signature.¹ The provisions of the Act are summarized below. The Act will provide significant relief and flexibility for registered investment companies that intend to qualify for the beneficial tax treatment granted to regulated investment companies ("RICs") under Subchapter M of the Internal Revenue Code of 1986, as amended, as well

as for their advisors and administrators. In anticipation of the implementation of the Act, RICs should review the new rules and consider whether strategic or practical changes may be in order, particularly with respect to:

- Dividend reinvestment plan discounts and fee and expense allocation arrangements (in light of the repeal of the “preferential dividend” prohibition);
- Capital loss planning (including the potential to increase tax-free returns of capital to shareholders by maximizing capital loss utilization);
- Pass-through of tax-exempt interest income and foreign tax credits in a RIC “fund of funds” structure; and
- Simplified reporting requirements for distributions to shareholders.

Changes in Tax Law for RICs

When signed, the Act will make following modifications to the current U.S. federal income tax law applicable to RICs:

I. Repeal of the “Preferential Dividend” Prohibition for Publicly-Offered RICs

- Under current law, a RIC is not entitled to a deduction for dividends paid for “preferential dividends” (meaning that, with limited exceptions, the amount of the dividend must be pro rata among shareholders within each class).
- The Act will repeal the preferential dividend prohibition with respect to publicly-offered RICs with at least 500 shareholders.
- Practically speaking, this will allow increased flexibility under the tax law for RICs to structure dividend reinvestment plan discounts and management fee waivers or discounts among classes of shares or within a single class of shares. Prior to the Act, such discounts and unequal expense allocations could cause a RIC to run afoul of the preferential dividend prohibition.
- Different levels of advisory fee waivers between classes of the same fund and cross-class subsidies may still be problematic under applicable securities laws, including Rule 18f-3 under the Investment Company Act of 1940.
- Under current law the preferential dividend prohibition also applies to real estate investment trusts (“REITs”). Despite significant lobbying by the REIT industry, Congress did not extend the Act’s repeal of the preferential dividend prohibition to REITs. Thus, at least for the time being, RICs will have greater flexibility than REITs under the tax law to structure dividend reinvestment plan discounts and variable fee sharing arrangements, although it is difficult to identify a coherent tax policy for this disparate treatment.

II. RIC Gross Income and Asset Diversification Test Cures

The Act provides new cure provisions for inadvertent failures of the RIC gross income test and asset diversification tests.

- Inadvertent failures of the gross income test can be cured by paying a tax equal to the failure.
- *De minimis* asset diversification test failures (due to the ownership of assets the total value of which does not exceed the lesser of 1% of the total value of the RIC’s assets at the end of

the quarter or \$10,000,000) can be cured with no penalty if the RIC comes back into compliance within six months after the failure is identified.

- Asset diversification test failures other than *de minimis* failures can be cured if (i) the failure was due to reasonable cause, (ii) the RIC timely notifies the IRS of the failure, (iii) the RIC disposes of the asset causing the failure, and (iv) the RIC pays an excise tax equal to the greater of \$50,000 or the highest corporate tax rate times the income from the non-qualifying asset during the period of the failure.

III. Capital Loss Carryforwards

- The Act permits a RIC to carry forward net capital losses indefinitely (compared to eight years under current law).
- The Act also provides that a RIC's capital loss carryforwards will retain their character as long-term or short-term (compared to current law treatment where all capital loss carryforwards are first treated as short-term capital losses).

IV. RIC Designations and Reporting of Distributions

The Act eliminates the current legal requirement that a RIC send designation notices to shareholders within 60 days of the end of the RIC's tax year regarding the designation of capital gain dividends, exempt-interest dividends, and certain other designations. The Act provides simplified reporting for such information, typically on the Form 1099 provided by the RIC to its shareholders.

V. Calculation of Earnings and Profits for a RIC

- The Act permits a RIC to deduct capital loss carryforwards and certain expenses related to exempt interest income when calculating current earnings and profits (which is relevant for determining whether a distribution to shareholders is a taxable dividend or a tax-free return of capital).
- Practically speaking, this provision may permit a RIC with capital loss carryforwards and exempt-interest expenses to increase the amount of its distribution that is a tax-free return of capital.

VI. Pass-Through of Tax-Exempt Interest and Foreign Tax Credits in a "Fund of Funds" Structure

- The Act permits an upper-tier RIC in a "fund of funds" structure to pass through its tax-exempt interest and foreign tax credits to shareholders. Under this provision, if at least 50% of a RIC's assets consist of shares in other RICs, then the RIC may pass through such income and credits without regard to the requirement under current law that 50% of its assets consist of tax-exempt bonds or foreign securities, as applicable.
- Practically speaking, this will permit an upper-tier fund in a "fund of funds" structure to be formed as a RIC rather than a grantor trust, and thus avoid the burdensome reporting requirements that have applied to grantor trusts under the widely-held fixed income trust (or "WHFIT") rules since 2007.

VII. RIC Treatment of "Spill-Over" Dividends

- Under current law, a RIC can satisfy its distribution requirement for Year 1 by paying "spillover dividends" in Year 2 (*i.e.*, dividends declared before the RIC's Year 1 tax return due date, including extensions, and paid before the RIC's first regular dividend in Year 2).

- The Act permits a RIC to declare a spillover dividend later if it has an extension for filing its Year 1 tax return.
- The Act also permits a spillover dividend to be paid before the first Year 2 dividend of the same type (*i.e.*, capital gain dividends, exempt-interest dividends, etc.), effectively permitting a RIC to distribute other types of income in Year 2 before the spillover dividend is paid.

VIII. Redemptions by Open-End RICs

- The Act provides that if an open-end RIC with at least 500 shareholders makes a distribution to a shareholder to satisfy the shareholder's redemption demand, then such distribution will be treated as an exchange of stock (generally meaning capital gain or loss to the shareholder) rather than a distribution of property that is equivalent to a dividend (generally meaning ordinary income to the shareholder extent of the RIC's earnings and profits). This result was unclear under prior law.
- The Act also provides that if an upper-tier RIC in a "fund of funds" structure redeems its shares in a lower-tier open-end RIC and realizes a loss, the upper-tier RIC will now be able to recognize such loss for tax purposes notwithstanding certain loss limitation rules that otherwise apply to related-party transactions.

IX. Deferral of Late-Year Losses

- The Act provides increased flexibility for a RIC to defer recognition of late-year capital and ordinary losses until the following year.
- Practically speaking, this will allow a RIC with a non-calendar fiscal year more flexibility in timing losses to avoid the imposition of the 4% excise tax on undistributed income.

X. Excise Tax Rules Applicable to RICs

- Under current law, the 4% excise tax on undistributed income does not apply to a RIC that is wholly-owned by qualified tax-exempt pension plans and certain insurance company separate accounts. The Act expands this list to include qualified Sec. 403 annuity plans, IRAs/Roth IRAs, Sec. 414(b) and 457 government plans, Sec. 501(c)(18) exempt pension plans, and other RICs with such qualified owners.
- As a revenue raiser to pay for other provisions in the Act, the amount of net capital gain that a RIC must distribute each calendar year to avoid the 4% excise tax will increase from 98% to 98.2%.

No Change to Current RIC Rules Regarding Commodities

- Under current law, a RIC's direct investment in commodities will not generate qualifying income for purposes of the RIC gross income test.
- The original version of the Act passed by the House would have added income from commodities and derivatives on commodities to the list of qualifying income for the RIC gross income test. However, the final version of the Act passed by the Senate and House does not change current law regarding income from commodities for purposes of the RIC gross income test.
- Accordingly, the Act will not change the current law restriction on a RIC making direct investments in commodities. However, as under current law, it is generally possible in

certain circumstances for a RIC to make indirect investments in commodities through structured notes or subsidiary corporations.

Conclusion

If signed by the President as expected, the Act will provide significant flexibility for RICs and their advisors and administrators. RICs should review the provisions of the Act in anticipation of its passage to consider potential strategic and procedural alternatives that may soon become available.



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¹ The Regulated Investment Company Modernization Act of 2010 (H.R. 4337) was originally approved by the House on September 28, 2010. The Senate modified and approved the bill on December 8, 2010, and the House passed the modified bill on December 15, 2010.