

H.R. 4337

Regulated Investment Company Modernization Act of 2009

DECEMBER 16, 2009

Summary: The *Regulated Investment Company Modernization Act of 2009* would modernize various technical rules governing the tax treatment of regulated investment companies (RICs) under the Internal Revenue Code. The Joint Committee on Taxation estimates that the cost of these provisions would be \$188 million over the next ten years.

I. CAPITAL LOSS CARRYOVERS OF REGULATED INVESTMENT COMPANIES

Capital loss carryovers of regulated investment companies. RICs are designed to provide individual investors with the ability to invest in a diversified pool of professionally-managed investments. As a result, the tax rules are generally designed so that investors are taxed similarly whether they invest directly in securities or indirectly through a RIC. Individuals investing directly in securities are permitted unlimited carryforwards of their net capital losses. However, under current law, RICs may only carry forward their capital losses for up to eight taxable years. If a RIC does not generate enough capital gains over the eight-year period to offset its capital loss carryforwards, gains of a RIC must be distributed to shareholders (and therefore would be subject to tax) even though, economically, the RIC may still be in a cumulative net loss position. The bill would update the capital loss carryforward rules for RICs so that they match the capital loss carryforward rules for individuals. As a result, a RIC would be permitted unlimited carryforwards of their net capital losses under the bill. *This proposal is estimated to cost \$30 million over 10 years.*

II. MODIFICATION OF GROSS INCOME AND ASSET TESTS OF REGULATED INVESTMENT COMPANIES

Income from commodities counted toward gross income test of regulated investment companies. Under current law, a RIC must derive at least ninety percent (90%) of its income from certain enumerated sources of “good income” (e.g., dividends, interest, gains from the sale or other disposition of stock, etc). Under current law, commodities

are not one of these enumerated sources. As a result, a RIC cannot derive more than ten percent (10%) of its gross income from commodities. Financial advisors today encourage clients to diversify across a broad range of asset classes, including commodity investments. This aspect of current law prevents shareholders from accessing commodity investments through mutual funds. The bill would include commodities as a source of good income. *This proposal is estimated to have a negligible revenue effect over 10 years.*

Savings provision for failures of regulated investment companies to satisfy gross income test. As mentioned above, a RIC must derive at least ninety percent (90%) of its gross income from certain enumerated sources of “good income.” Under current law, if a fund fails to comply with this requirement by even one dollar it is subject to tax as a corporation at a thirty-five percent (35%) rate. The bill would permit a RIC to cure inadvertent failures to comply with the gross income test by paying a tax equal to the amount by which the RIC failed the gross income test. *This proposal and the proposal immediately below are estimated to raise less than \$500,000 over 10 years.*

Savings provision for failures of regulated investment companies to satisfy gross asset test. In addition to the gross income test mentioned above, a RIC must also satisfy certain asset diversification tests. Similar requirements apply to real estate investment trusts (REITs). Unlike RICs, REITs have statutory means to remedy inadvertent failures of such tests. For example, if a REIT fails the asset tests by a de minimis amount and the REIT comes into compliance within six months after it identifies the failure, then the REIT is treated as satisfying the asset tests. For non-de minimis asset test failures, a REIT can avoid disqualification under subchapter M if the failure is due to reasonable cause (and not willful neglect) and the REIT notifies the IRS, disposes of the assets, and pays an excise tax equal to the greater of (i) \$50,000 or (ii) the highest corporate tax rate times the net income from the bad assets during the period of failure. The bill would extend these REIT remedies to RICs. *The estimate for this proposal is included in the estimate immediately above.*

III. MODIFICATIONS OF RULES RELATED TO DIVIDENDS AND OTHER DISTRIBUTIONS

Modification of dividend designation requirements for RICs. Under current law, RICs are required to send a written designation notice to shareholders within sixty (60) days of the end of the RIC’s taxable year notifying the shareholders of the tax treatment of various distributions made during the course of the RIC’s taxable year. This requirement predates the comprehensive Form 1099 information reporting requirements that are also imposed on RICs that provide shareholders with the same information. The bill would eliminate the now-obsolete requirement that RICs must send a written

designation notice to shareholders within sixty (60) days of the end of the RIC's taxable year. *This proposal and the proposal immediately below are estimated to cost less than \$500,000 over 10 years.*

Modification of dividend allocation rules for RICs. A RIC may distribute its net capital gain income through specially-designated capital gain dividends. The RIC's net capital gain is determined at the end of the RIC's taxable year. If a RIC has a taxable year other than the calendar year, it will need to determine whether a dividend made prior to December 31 is a capital gain dividend when it sends information returns (Form 1099) to its shareholders. However, the amount that a RIC expects to be a capital gain dividend at the end of the calendar year may be different from the amount that ultimately is allowed to be treated as a capital gain dividend at the end of the taxable year. If this occurs, the RIC must send out amended Form 1099s and shareholders must file amended returns clarifying that the dividend was not, in fact, a capital gain dividend. This can be both confusing and burdensome for taxpayers. Rather than force funds and taxpayers to file amended returns for the prior calendar year, the bill would allow the fund to first reduce capital gain dividends in the subsequent calendar year by the amount of the excess capital gain dividends reported in the prior calendar year. Similar rules would apply to other types of specially-designated dividends (e.g., exempt-interest dividends, short-term capital gain dividends and interest-related dividends). *The cost of this proposal is included in the estimate immediately above.*

Earnings and profits of regulated investment companies. Under current law, the current earnings and profits of a RIC are not reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year. In the case of tax-exempt bond funds, this rule can cause inappropriate results that result in shareholders being overtaxed. In particular, if a RIC that invests exclusively in tax-exempt obligations distributes an amount greater than its net tax-exempt interest income for the year, that excess is economically a return of capital to shareholders. However, because certain deductions associated with tax-exempt income are disallowed, such excess is treated under current law as a dividend out of current earnings and profits. The bill would fix this aspect of current law by allowing certain disallowed deductions associated with tax-exempt income to be taken into account in calculating earnings and profits. *This proposal is estimated to cost less than \$500,000 over 10 years.*

Pass-through of exempt-interest dividends and foreign tax credits in fund-of-funds structure. Under current law, a RIC is allowed to pass-through tax-exempt interest and foreign tax credits if more than fifty percent (50%) of the RIC's assets are comprised of municipal bonds (in the case of exempt-interest income) or stock and securities issued by foreign corporations (in the case of foreign tax credits). However, if a RIC invests exclusively in shares of other RICs (a so-called fund-of-funds structure) that pass through tax-exempt interest or foreign tax credits, the top-tier RIC is limited in its ability to

separately pass these tax attributes on to its shareholders because it does not technically meet this fifty percent (50%) requirement. As the mutual fund industry has evolved, this aspect of current law has become problematic for the many fund-of-funds structures. The bill would allow a fund of funds that invests ninety-five percent (95%) of its assets in cash and cash items and interests in other RICs to pass-through tax-exempt interest and foreign tax credits without regard to the fifty percent (50%) requirement. *This proposal is estimated to cost \$39 million over 10 years.*

Modification of rules for spillover dividends of regulated investment companies.

Under current law, certain dividends paid by a RIC after the end of its taxable year may be taken into account in computing the RIC's dividends paid deduction for such taxable year. In order for a dividend to qualify for this "spillover" treatment, the RIC must declare the dividend by the due date for filing its tax return for the taxable year. In addition, the RIC must pay the dividend to shareholders within the twelve (12) months following the end of such taxable year and not later than the date of the first regular dividend paid by the RIC after such declaration. The requirement that a "spillover" dividend be paid no later than the next regular dividend paid after the "spillover" dividend is declared may unnecessarily restrict a RIC's flexibility in determining when to make distributions. For example, a fund may wish to make a capital gain distribution before making its spillover dividend. The bill would allow a RIC to make a spillover dividend with the first dividend payment of the same type of dividend. It would also limit the time period for making a spillover dividend to the 15th day of the ninth month following the close of the taxable year or, in the case of an extension of time for filing the company's return for the taxable year, the due date for filing such extended return. *This proposal is estimated to cost less than \$500,000 over 10 years.*

Return of capital distributions of regulated investment companies. If a RIC makes a return of capital distribution, it must allocate this return of capital distribution pro rata over all distributions made during the taxable year. RICs are also required to distribute essentially all of their calendar-year income by December 31 of each calendar year in order to avoid the annual RIC excise tax. The interaction between these two rules can be problematic. If a RIC makes a computational error over the course of the taxable year, distributions that the RIC treats as dividends in the pre-January 1 period of the taxable year could turn out to be, in part, return of capital distributions. This can be particularly problematic for funds because they are required to track the cost basis of each share (which is affected by return of capital distributions) and also to notify their shareholders of the amount of dividends that each shareholder receives during the calendar year. Substantial confusion can arise if shareholders receive amended information returns and cost basis statements. In order to remedy this situation, the bill would provide that a RIC's earnings and profits shall be allocated first to distributions made prior to December 31 and then to distributions occurring after December 31 instead of requiring earnings

and profits be allocated pro rata over all distributions during the taxable year. *This proposal is estimated to raise less than \$500,000 over 10 years.*

Exchange treatment for redemptions of stock of a regulated investment company.

Under current law, mutual funds can face difficulties in determining whether a distribution in partial redemption of stock should be treated as an exchange of fund shares or as a dividend for tax purposes. This difficulty arises because current law requires RICs to determine whether a distribution is “essentially equivalent to a dividend.” Literal application of this requirement could require testing of each partial redemption, of which there may be hundreds or thousands a day, to determine if each partial redemption should be treated as an exchange or as a dividend. The bill would simplify this determination by allowing all publicly-offered RICs with shares that are redeemable upon demand to treat distributions in redemption of stock as an exchange. *This proposal and the proposal immediately below are estimated to cost \$94 million over 10 years.*

Loss-deferral rule for redemptions of stock in fund-of-funds structures. In a fund-of-funds structure, a lower-tier RIC may be required to redeem shares held by an upper-tier RIC when shareholders in the upper-tier RIC redeem their shares. Under current law, any loss from the sale or exchange of property between members of a controlled group of corporations is deferred until the property is transferred outside of the group. This rule was developed in the context of corporate transactions, not in the context of mutual fund investment structures. The bill would provide that this loss-deferral rule does not apply to the redemption of stock of a RIC if the redemption is upon the demand of a shareholder which is another RIC. *The cost of this proposal is included in the estimate immediately above.*

Repeal of preferential dividend rule for publicly offered regulated investment companies.

Under current law, RICs are allowed a deduction for dividends paid to shareholders (the “dividends paid deduction”). In order for a dividend to qualify for the dividends paid deduction, it must not be a “preferential dividend.” A dividend is considered to be preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock as compared with other shares of the same class, and with no preference to one class compared with another except to the extent the class is entitled to such preference. This preferential dividend rule was adopted prior to enactment of the Investment Company Act of 1940, which contains its own protections against preferential dividends, as a means of ensuring that investors in mutual funds would be treated equally and fairly. Today, the 1940 Act and the Securities and Exchange Commission ensure that investors in mutual funds are treated equally and fairly. The preferential dividend rules contained in the tax code have largely served as an unintended trap for mutual funds that make inadvertent processing or computational errors. The bill would repeal the preferential dividend rules contained in the tax code for

publicly offered RICs. *This proposal is estimated to have a negligible revenue effect over 10 years.*

Deferral of late-year losses of regulated investment companies for income tax purposes. Under current law, a RIC must distribute essentially all of its calendar-year income (pre-October 31 income in the case of capital gains) by December 31 of each calendar year. In general, RICs must make these distributions even if their taxable year does not end on December 31. As a result, a RIC may suffer losses after December 31 (or, in the case of capital gains, after October 31) that reduce its taxable income, net capital gain, or current earnings and profits. Such reductions can change the information that should have been reported on a shareholder's information return or cost basis statement. Substantial confusion can arise if shareholders receive amended information returns and cost basis statements. In order to remedy this situation, the bill would allow a RIC to elect to treat a post-December 31 loss (or, in the case of capital gains, a post-October 31 loss) as arising on the first day of the fund's next taxable year. *This proposal is estimated to cost less than \$500,000 over 10 years.*

IV. MODIFICATIONS OF RULES RELATED TO THE REGULATED INVESTMENT COMPANY EXCISE TAX

Excise tax exemption for certain regulated investment companies owned by tax-exempt entities. Under current law, an annual excise tax is imposed on RICs that fail to distribute essentially all of their taxable income at the end of the calendar year. This excise tax is intended to reduce the opportunities for shareholders to defer taxation on investment earnings through RICs. RICs, in which all the shareholders are section 401(a) trusts or segregated accounts underlying variable insurance contracts, are not subject to the annual RIC excise tax because these shareholders would not benefit from deferring tax through a RIC. There are other pension and retirement plans that similarly are not subject to tax on RIC distributions. The bill would extend the excise tax exemption to RICs that are owned by these other tax-exempt entities as well. *This proposal is estimated to have a negligible revenue effect over 10 years.*

Deferral of certain gains and losses of regulated investment companies for excise tax purposes. Solely for purposes of the annual RIC excise tax, a RIC is allowed to treat certain ordinary income derived after October 31 as being derived on the first day of the following calendar year. The bill would expand this rule to cover all ordinary gains or losses from the sale, exchange, or other disposition of (or termination of a position with respect to) property, including foreign currency gains and losses. *This proposal is estimated to cost less than \$500,000 over 10 years.*

Distributed amount for excise tax purposes determined on the basis of taxes paid by regulated investment company. RICs generally try to distribute all of their income to shareholders to avoid corporate-level tax. Some funds holding municipal bonds, however, may choose to pay the tax on any market discount on the bonds, rather than make taxable distributions to their shareholders, because these shareholders expect to receive tax-exempt interest from the fund. Under current law, a RIC that chooses to pay tax must make quarterly estimated tax payments. For purposes of the annual RIC excise tax, RICs are treated as having distributed amounts on which tax is imposed; however, estimated tax payments are not treated as being distributed until the end of the taxable year. Therefore, if a RIC has a taxable year that is different from the calendar year, the RIC is unable to take estimated tax payments made after the start of the current taxable year and before January 1 into account for purposes of the annual RIC excise tax. The bill would allow these estimated tax payments to be taken into account for purposes of the annual RIC excise tax. *This proposal is estimated to cost less than \$500,000 over 10 years.*

V. OTHER PROVISIONS

Repeal of assessable penalty with respect to liability for tax for regulated investment companies. Under current law, a RIC can distribute a “deficiency dividend” if it has a tax deficiency with respect to a previous tax year because it failed to distribute all of its investment company taxable income. Such a deficiency dividend is treated by the RIC as a deductible dividend paid with respect to the prior taxable year. As a result, the deficiency dividend eliminates the deficiency in the prior taxable year. As a penalty for making a deficiency dividend, a RIC is subject to an interest charge plus an additional penalty equal to the lesser of (i) the amount of the interest charge or (ii) fifty percent (50%) of the amount of the deficiency dividend. REITs may also make deficiency dividends. However, REITs are only subject to the interest charge. They are not subject to the additional penalty that RICs must pay under current law. The bill would conform the RIC and REIT deficiency dividend rules and repeal the additional penalty that applies to RICs making a deficiency dividend. RICs, like REITs, would continue to be subject to the interest charge. *This proposal is estimated to cost less than \$500,000 over 10 years.*

Modification of sales load basis deferral rule for regulated investment companies. Under current law, in certain situations shareholders in a RIC are required to increase their basis in RIC stock by the amount of a load charge that was paid with respect to previously-owned RIC stock. Under current law, there is no time limitation on this rule. As a result, many years can pass between the payment of the initial load charge, the sale of the RIC stock that bore the load charge and the subsequent acquisition of new RIC stock. This can create administrative problems for both shareholders and funds. The bill would limit the application of this rule to cases where a taxpayer acquires new RIC stock

before January 31 of the calendar year after disposing of the initial RIC stock that bore the load charge. *This proposal is estimated to cost \$25 million over 10 years.*