INVESTMENT COMPANY INSTITUTE

December 20, 2002

BY HAND

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REG-154116-02; REG-154115-02; REG-154429-02;
REG-154423-02; REG-154426-02; REG-110311-98)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Application to Investment Company Industry of Tax Shelter Regulations

Dear Sir or Madam:

The Investment Company Institute,[1] as noted in our September 5, 2002 letter (enclosed) on enforcement proposals for abusive tax avoidance transactions, supports the Treasury Department's initiative to develop broad, yet appropriate, requirements for disclosing, registering and maintaining lists of potentially abusive tax avoidance transactions under Sections 6011, 6111 and 6112.[2] For the reasons presented in our September 5 letter, however, many of the Treasury Department's concerns with abusive tax avoidance transactions are not generally applicable to regulated investment companies ("RICs").[3] Consequently, we are pleased that the recently promulgated temporary and proposed regulations under section 6011[4] expressly exempt RICs from the disclosure requirements relating to loss transactions and book-tax differences.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,990 open-end investment companies ("mutual funds"), 504 closed-end investment companies and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.615 trillion, accounting for approximately 95% of total industry assets, and over 88.6 million individual shareholders.

[2] All section references are to the Internal Revenue Code of 1986, as amended, and to regulations promulgated thereunder.

[3] A RIC is a corporate investment vehicle registered under the Investment Company Act of 1940 that elects the tax treatment provided by Subchapter M of the Internal Revenue Code.

[4] The regulations under Section 6011 involve disclosure of certain reportable transactions; those under Section 6111, which have not been revised, involve registration of confidential corporate tax shelters; those under Section 6112 involve maintenance of lists of persons participating in reportable or registered transactions.

Nevertheless, we remain concerned that the recently promulgated regulations could be read to place undue burdens on RICs, certain similar investment vehicles and their investment advisers that appear inappropriate given the manner in which the industry operates and the number of transactions the industry participates in each day. Future enactment of the penalty provisions considered during the 107th Congress – that would have penalized every failure (including inadvertent failure) to comply with the requirements of Sections 6011, 6111 and 6112[5] – would increase significantly the level of our concern.

We recommend, for the reasons discussed below, that the recently promulgated regulations be clarified as follows:

First, the exceptions for RICs, provided by Temp. and Prop. Treas. Reg. Section 1.6011-4T(b)(8)(ii), from the requirements to disclose loss transactions and book-tax differences should be applied as well to:

partnerships held exclusively by RIC partners (with one narrow exception discussed below);

investment vehicles that invest exclusively in RICs, such as variable insurance product separate accounts and qualified tuition programs (*i.e.*, Section 529 plans); and

those unit investment trusts registered, like RICs, under the Investment Company Act of 1940 (the "1940 Act") that are organized as grantor trusts and hence cannot qualify for RIC status.

Second, the regulations should provide an exception for RICs and similar investment vehicles, as described above, from the requirement to disclose transactions with brief asset holding periods.

Third, the scope of the reportable transaction participation requirement should be clarified so that an investor will not be treated as a participant unless the investor knows or has reason to know that the transaction is a reportable transaction and the investor's taxable income would be increased if any of the expected federal income tax benefits were disallowed.

Fourth, the regulations should clarify that a contractual protection does not include (a) a bondholder's right to an increased yield on a purported tax-exempt bond if the bond is determined to be taxable or (b) the put feature in a synthetic municipal instrument (of the type described in Revenue Procedure 2002-68) where the put right is intended largely to ensure that the instrument may be held by a tax-exempt money market fund.

[5] S. 2498 and H.R. 2520.

Fifth the list maintenance requirements should clarify that:

> an investment adviser to RICs and other 1940 Act-registered investment vehicles is not a material advisor with respect to investment advice provided to such vehicles in the ordinary course of business so long as the amount of compensation received does not vary based upon the extent of tax advice and is not dependent on the investment producing any specific tax results; and
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> to the extent that an investment adviser to RICs and other 1940-Act registered investment vehicles is treated as a material advisor, the material advisor needs to disclose a reportable transaction only if the material advisor knows or has reason to know that the RIC or similar investment vehicle has to disclose the transaction.

Finally, we request that Treasury consider these comments on an expedited basis and permit sufficient time for RICs and other 1940-Act registered investment vehicles to prepare to comply with the regulations. These entities will need adequate time to develop systems to identify those transactions, among the many thousands they typically execute each year in the normal course of their operations, that will be subject to the final regulations.

I. Exceptions Provided to RICs Should Cover Certain Other Investment Vehicles

The Institute appreciates the exceptions for RICs provided by Temp. and Prop. Treas. Reg. section 1.6011-4T(b)(8)(ii) from the requirements to disclose loss transactions and book-tax differences. These exceptions will eliminate the disclosure of two types of transactions that, for the reasons set forth in our September 5 letter, lack the potential to be tax shelters.

We submit that these exceptions should be extended to three other types of investment vehicles that either hold only RICs or are required to register under the same securities law -- the Investment Company Act of 1940 -- under which RICs must register. These investment vehicles are subject to conditions that likewise limit their potential for tax shelter abuse. Specifically, these exceptions should be applied to:

> partnerships held exclusively by RIC partners (subject to one narrow exception);
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> investment vehicles that invest exclusively in RICs, such as variable insurance product separate accounts and qualified tuition programs (*i.e.*, Section 529 plans); and
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> those unit investment trusts registered, like RICs, under the 1940 Act that are organized as grantor trusts and hence cannot qualify for RIC status.

A. Partnerships With RIC Partners

The master fund in a master-feeder structure should be exempt from disclosure of loss transactions and book-tax differences where the master fund is registered under the 1940 Act

and all of the feeder fund investors are either RICs or the investment management firm that has created the structure (and that made an initial investment in the master fund so that the master fund would have two partners and could qualify as a partnership). The master-feeder structure was created to enhance distribution opportunities to different groups of investors in RICs. As an aggregation of multiple feeders, the master will be larger than each of these feeder fund RICs and will likely engage in at least the same number of transactions as each feeder would if it held its assets directly. It would be anomalous to require disclosure of loss transactions and book-tax differences at the master fund level even though these same transactions would be excepted from disclosure at the feeder fund level.

A partnership also should be exempt from disclosure of loss transactions and book-tax differences where the partnership is created to allow multiple RICs to invest a portion of their assets. For example, several balanced funds (that invest in both equities and bonds) might hold bonds through a lower-tier partnership in order to achieve economies of scale. In this case as well, it is anomalous to require disclosure of loss transactions and book-tax differences at the lower-tier partnership level even though these same transactions would be excepted from disclose at the upper-tier RIC level.

B. Investment Vehicles that Invest Exclusively in RICs

Investment vehicles that invest exclusively in RICs,[6] such as certain variable insurance product separate accounts and qualified tuition programs established under Section 529 of the Internal Revenue Code ("Section 529 plans"), should be exempt from disclosure of loss transactions and book-tax differences. So long as the investments made by the RIC that create loss transactions or book-tax differences do not give rise to a tax shelter disclosure reporting obligation, it would be anomalous to require reporting of these two types of transactions by vehicles that invest exclusively in RICs. Moreover, to the extent that the investing vehicles are themselves tax-deferred entities, there should be even less concern about possible tax abuse.

C. Unit Investment Trusts

Unit investment trusts ("UITs") registered under the 1940 Act that cannot avail themselves of RIC status because they are organized under state law as grantor trusts likewise should be exempt from disclosure of loss transactions and book-tax differences. Not only do UITs operate under the same rigid securities laws that apply to RICs, but their portfolios generally are fixed. Thus, UITs have essentially no ability to manipulate their investments for tax abuse purposes. However, tax shelter disclosure might be required, absent an exception, where a UIT portfolio security suffers precipitous decline, as UITs generally are required to dispose of such troubled securities. Requiring tax shelter disclosure in this case would appear to serve no greater public interest than requiring such disclosure where a RIC invests in a similar security.

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[6] The only permissible non-RIC investments would be cash and cash-items.

II. Transactions with Brief Holding Periods

The Institute previously recommended that RICs be exempt from the disclosure requirements with respect to transactions involving brief asset holding periods. Our specific concern is that the $250,000 tax credit threshold for reporting might be met routinely by large RICs incurring significant foreign withholding tax on overseas investments; even though the credits arise from taxes actually paid on investment income that will be distributed currently to shareholders and the amount of any such credit that flows through to any individual RIC shareholders most likely would be quite small and almost surely significantly less than $250,000. Consequently, we continue to believe that a RIC exception for reporting transactions involving foreign tax credits is appropriate.[7]

III. Participation in a Reportable Transaction

Lack of guidance regarding when a taxpayer will be deemed to have "participated, directly or indirectly, in a reportable transaction" creates uncertainty in applying the tax shelter disclosure requirements to RICs.[8] In particular, it appears that RICs may be required to disclose transactions in circumstances in which they have no knowledge that a reportable transaction has occurred, such as because one participant in a transaction was offered the transaction under conditions of confidentiality, received contractual protection, or incurred a loss in excess of the relevant threshold. This requirement could be particularly burdensome for RICs routinely engaging in thousands of portfolio transactions each year.

To ensure manageable application of the disclosure regulations to RICs, the Institute recommends that the regulation be modified to provide that an investor will not be treated as a participant unless the investor knows or has reason to know that the transaction is a reportable transaction and the investor's taxable income would be increased significantly if any of the expected federal income tax benefits were disallowed. Significant might be defined as $10,000 for individuals and trusts or $50,000 for all other entities. This proposal would ensure reporting by precisely the taxpayers from whom disclosure would be useful.

IV. Contractual Protection Transactions

Application of the tax shelter disclosure requirements to RICs also is unclear because of uncertainty whether a contractual protection includes (a) a bondholder's right to an increased yield on a purported tax-exempt bond if the bond is determined to be taxable or (b) the put feature in a synthetic municipal instrument (of the type described in Revenue Procedure 2002-68) where the put right is intended largely to ensure that the instrument may be held by a tax-exempt money market fund. As these two features are intended merely to ensure that an obligation intended to be appropriate for a particular tax-exempt bond fund is appropriate and

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[7] Should our recommendation not be adopted, we request clarification that the disclosure requirement applies to a RIC only where the RIC elects under section 853 to flow through foreign tax credits to its shareholders. If the RIC deducts the foreign taxes, rather than flowing through as a foreign tax credit, there appears to be no tax credit subject to short holding period transaction reporting.

[8] Temp. And Prop. Treas. Reg. § 1.6011-4T(a).

provides a market-rate taxable-equivalent yield, they would not appear to be the types of transactions for which disclosure is intended. Confirmation of the inapplicability of the contractual protection test to these routine transactions would be appreciated.

V. List Maintenance Requirements

The list maintenance regulations require that any person who organizes or sells any interest in a potentially abusive tax shelter (a "material advisor") must maintain a list identifying each person who was sold an interest in such shelter and containing other information required by regulations. A material advisor is defined as any person who (i) receives, or expects to receive, at least a minimum fee in connection with a transaction that is a potentially abusive tax shelter (defined to include a transaction that the advisor knows or has reason to know is a reportable transaction at the time the transaction is entered into), and (ii) makes or provides any statement, oral or written, to any person as to the potential tax consequences of that transaction.

The Institute is concerned that the material advisor definition could be read to include investment advisers to RICs that are compensated by a management fee (typically calculated as a percentage of assets under management) for providing conventional investment advice, since the advisors also provide tax-related advice, such as advice regarding possible tax consequences under Subchapter M of the Code. Should the term material advisor be construed so broadly, mutual fund investment advisers and their affiliates could be required to maintain extraordinarily detailed lists of the investment vehicles they advise (perhaps including each investor in each of these vehicles), the portfolio investments of each such vehicle and, perhaps, the time period during which each investment was held.

The Institute also is concerned that the RIC-specific exceptions provided by Temp. and Prop. Treas. Reg. section 1.6011-4T are not expressly available under the list maintenance regulations. Absent these exceptions, an investment advisor treated as a material advisor could be required to maintain a list for a reportable transaction (such as a loss transaction or a book-tax difference) that no participant is required to disclose.

Consequently, we recommend that an investment adviser to RICs and other 1940 Act-registered investment vehicles not be treated as a material advisor with respect to investment advice provided to such vehicles in the ordinary course of business so long as the amount of compensation received does not vary based upon the extent of tax advice and is not dependent on the investment producing any specific tax results. In addition, we recommend that an investment adviser to RICs and other 1940-Act registered investment vehicles, which nevertheless is treated as a material advisor, be required to include an investor on a reportable transaction list only if the material adviser knows or has reason to know that the investor is required to disclose that transaction. Where no investor to a transaction is required to disclose a transaction, the material adviser would have no duty to maintain a list for that transaction.

VII. Effective Date

Application pursuant to the regulation's effective date to transactions arising after December 31, 2002 will create significant difficulties for RICs and the other vehicles described in this letter. Among other things, application of many of the regulation's requirements to the industry remains unclear. Given the size of the firms in the industry, the compliance mechanisms needed to monitor for reportable transactions must be largely automated. Without clear guidance regarding the regulation's scope, the necessary computer programming cannot be ensured.

For these reasons, we request that Treasury consider these comments on an expedited basis. In addition, we request that Treasury provide sufficient time for RICs and similar entities to comply with the regulations. Such a delay will provide these entities with adequate time to develop systems to identify those transactions, among the many thousands they typically execute each year in the normal course of their operations, that will be subject to the final regulations.

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We support fully the Treasury Department's objective of ensuring compliance with the Internal Revenue Code by requiring disclosure of potentially abusive transactions. Given the desire for broadly-applicable disclosure requirements, we appreciate the exceptions provided for RICs from the disclosure requirements for loss transactions and book-tax differences.

The recommendations made in this letter, we submit, are consistent with your goals and the existing exceptions. Please contact Keith Lawson, the Institute's Senior Tax Counsel, at 202-326-5832, or me, at 202-326-5835, if you would like to discuss these recommendations or request any additional information from us.

Sincerely,

Lisa Robinson
Assistant Counsel

Enclosure

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