RIC Modernization Act of 2010

An ICI-Hosted Webinar

February 7, 2011

1:00 - 2:30 p.m. (EST)

Webinar Presenters

- Keith Lawson, Senior Counsel -- Tax Law, ICI (Moderator)
- Gwen Shaneyfelt, Senior Vice President -- Global Taxation, Franklin Templeton Investments (and Chair, ICI Tax Committee)
- Stephen Fisher, Senior Vice President & Deputy General Counsel, Fidelity Investments
- Shawn Baker, Traditional Funds Tax Leader, PricewaterhouseCoopers LLP
- William Paul, Partner, Covington & Burling LLP

Savings Provision (Assets)

[Bill §201 – IRC §851(d)(2)]

- REITs have had asset savings provision since 2004
- New savings provision for RICs closely tracks the REIT model
- Applies if fail §851(b)(3) and don't qualify for relief under old §851 (d) -- now §851(d)(1)
- Two separate asset savings provisions
  - *de minimis* failures
  - other failures if due to reasonable cause
- Effective date - - tax years for which due date of return (with extensions) is after date of enactment

De Minimis Failures

- Failure due to ownership of assets the total value of which does not exceed the lesser of:
  - 1% of total assets at the end of the quarter, or
  - $10 million
- Fund must come into compliance within 6 months after end of quarter in which failure is discovered
  - either by disposing of assets or otherwise
- No reasonable cause requirement
- No toll charge
- No disclosure to IRS required

Questions Raised by *De Minimis* Savings Provisions

- How do you measure the 1% or $10 million?
  - Example 1: Fund has 49% "good" assets and 51% bad assets
  - Example 2: Fund has 46% "good" assets and 54% bad assets
    - One bad asset is a 6% position and if that were a 5% position, fund would have 51% good assets
- Time of cure
  - Language says have to cure after discovery
  - Failure may have been cured by asset sales/purchases or changes in relative values before discovery

Other Asset Test Failures

- Magnitude of failure does not matter
- Failure must be “due to reasonable cause and not due to willful neglect”
- Fund must file schedule with IRS describing each asset that caused the failure
- Fund must dispose of the assets listed on the schedule within 6 months of end of quarter in which failure is discovered or the requirements of §851(b)(3) must otherwise be met in that time period

Other Asset Test Failures

- Fund must pay a (deductible) tax equal to the greater of:
  - $50,000, or
  - an amount determined (under regulations to be issued) by applying the highest rate of tax in§11 (currently 35%) to the "net income" generated by the assets listed in the schedule during the period of failure
  - Period of failure
    - starts on first date the failure occurs from owning the assets on the schedule
    - ends on earlier of date the fund disposes of such assets or the end of the first quarter when there is no longer a failure of §851(b)(3)

Questions Raised by Asset Savings Provision

- Ability of advisors to give comfort on "reasonable cause"
  - IRS has refused to rule in REIT area
  - Closing agreements
- What assets should be listed on the schedule?
  - Example: Fund has 10 securities each of which is greater than 5% and that total 54% of assets. Should fund list its total position in each of the securities? or could the fund list the last-purchased security that represents more than 5%? or the last tax lot of that security?
  - Cure by disposing of all the assets on the schedule
    - implies not all >5% securities
  - Note that "net income" from assets on the schedule is part of tax calculation
    - how compute net income?
    - Example: Fund has $100 of ordinary income and a $90 capital loss from the assets that caused the failure
- When does period of failure begin?

Savings Provision (Income)

[Bill §201 – IRC §851(i)]

- Allows RICs to cure income-test failures if:
  - File Schedule in manner prescribed by Secretary;
  - Failure is due to reasonable cause, not willful neglect; and
  - Pay a (deductible) tax equal to "excess" non-qualified income.
- Effective date - Taxable years with respect to which due date of return (including extensions) is after 12/22/10.
- Observations
  - Apparently, only qualified income items go on Schedule.
  - Same "reasonable cause" issues as Asset Savings Provision.
  - Unlike Asset Savings Provision, no measurement issue.
  - Amount of tax: What is "excess" non-qualified income?

Savings Provision (Income) - Example

[Bill §201 – IRC §851(i)]

- Tax equals non-qualified income that exceeds 1/9 of qualified income. Assume RIC has:
  - 90 of qualified income; and
  - 15 of non-qualified income.
  - Tax is: 15 – [1/9 x 90] = 5.
- This is more than amount exceeding 10% "bad bucket:" Total gross income (105) x (0.10) = 10.5 allowable "bad bucket."
- But if RIC paid only 4.5 of tax, it would still be offside: 90 of qualified income and 10.5 of non-qualified income.
- By paying tax of 5, RIC gets onside: 90 qualified, 10 non-qualified.

Qualified Fund of Funds (QFF)

[Bill §303 – IRC §852(g)]

- QFF can pay exempt-interest dividends and pass through foreign tax credits without regard to 50% asset requirements in §852(b)(5) and§853.
  - "QFF" = RIC with at least 50% of assets invested in other RICs at close of each taxable quarter.
  - Effective date – Tax years beginning after 12/22/10.
- Observations
  - Creates parity for funds of funds.
  - Pass through may be possible even if QFF has less than 50% of its assets invested directly or indirectly in tax-exempt obligations or foreign stocks/securities.

Redemptions of Stock

[Bill §306 – IRC §267(f)(3)(D)]

- Repeals loss deferral when upper-tier RIC redeems shares of >= 50%-owned lower-tier RIC.
  - Effective date – Redemptions after 12/22/10.
- Observations
  - Creates parity for funds of funds.
  - Wash sale rules may still apply.

Redemptions of Stock (Continued)

[Bill §306 – IRC §302(b)(5)]

- Clarifies that redemptions of open-end RIC stock receive sale-or-exchange treatment.
  - Do not have to fit into other categories under§302(b).
  - Effective date – Redemptions after 12/22/10.
- Observations
  - Applies only to "Publicly Offered RICs:"
    - Continuously offered under '33 Act;
    - Regularly traded on established securities market; or
    - At least 500 shareholders at all times.

Spillover Dividend Rules

[Bill §304 – IRC §855]

Current Law

- Spillover must be declared by the due date of the tax return including extension
- Spillover must be paid by the date of the RIC's next regular dividend after it is declared

New Law

- Declaration by either the extended due date or the automatic extension deadline (i.e., eliminates the "extension issue")
- Paid by the next regular dividend of the same type (long-term and short-term capital gain dividends)

Effective date

- Applies to distributions in tax years beginning after December 22, 2010

Spillover Dividend Rules (cont'd)

[Bill §304 – IRC §855]

Initial considerations include

- Declaration and payment of spillover dividends
  - Maintain current procedures through the effective date
  - Impact of change on timing of declaration and payment
  - §19(a) of the 1940 Act
- Tax return extensions
  - Continued need for strong controls

Earnings & Profits

[Bill§302 – IRC§852(c)]

- Changes to amounts included in current E&P
  - Net capital loss carryforwards will reduce current E&P in the year that those losses offset distributable income
  - Expenses related to tax-exempt income reduce current E&P for funds eligible to pay exempt-interest dividends
  - Effective date - Tax years beginning after 12/22/10
- Observations
  - Matches the tax treatment to the economic reality of over distributions (Return of Capital rather than dividend)

Earnings & Profits (continued)

[Bill §305 – IRC §316(b)(4)]

- Change in allocation of E&P to distributions
  - Return of capital is first allocated to distribution made after December 31st, any remaining return of capital is allocated to distribution made prior to December 31st
- Observations
  - Reduces the chance that Forms 1099s will be amended

Loss Disallowance on Muni Fund Shares

[Bill §309 – IRC §852(b)(4)(E)]

- For daily dividend muni funds, repeals disallowance of losses on shares held for 6 months or less to extent of exempt-interest dividends.
  - Applies only to "regular" dividends.
  - Effective Date – RIC shares for which taxpayer's holding period begins after 12/22/10.
- Observations
  - § 852(b)(4) designed to prevent "buying" an exempt-interest dividend and then realizing a non-economic capital loss.
  - But not possible to buy a dividend if fund declares daily.

Preferential Dividend Rule

[Bill §307 – IRC §562(c)]

- IT'S REPEALED!!
  - For publicly offered RICs
    - Publicly offered
      - Same definition as used for redemptions of stock (slide 13)
  - Effective date – Tax years beginning after 12/22/10
- Observations
  - Only the tax rule is repealed
    - Other rules (*e.g.*, SEC rule 18f-3) still must be considered
  - Rev. Rul. 89-81 still applies
    - Must allocate all classes of income pro rata amongst all shareholders

Capital Loss Carryfowards

[Bill§101 – IRC§1212(c); Bill§302 – IRC§852(c)(1)(A)]

- Post-enactment capital losses now carryforward indefinitely
  - Capital losses retain their character (Short-term or long-term after appropriate netting)
  - Post enactment capital losses are used before pre enactment capital loss carryforwards
  - Effective date – Tax years beginning after 12/22/10
- Observations
  - Will result in different characterization of capital losses than under prior law
  - Deferred capital losses moved from pre enactment to post enactment period will be treated under new law
  - May want to consider changes to your lot selection method
  - Consider implications on the equalization calculation
  - Consider interplay with carryover rules of §381 -§384

Capital Loss Carryforward – Example

- Facts
  - Calendar year end fund
  - Capital Loss Carryforward
    - 12/31/05 $200,000
    - 12/31/11 $300,000 LT, $ 0 ST
  - Capital Gains 12/31/12 – $350,000 ST, $250,000 LT
- Result:

12/31/12	$350,000 ST	$250,000 LT
12/31/11	< 50,000> ST	<250,000> LT
12/31/05	<u><200,000></u>	___________
	$100,000 ST	$ 0 LT

Dividend Designation Requirement

[Bill§301 – IRC§852(b)(3); §860(f); §852(b)(5); §853; §853A; §854(b); §871(k); §855]

- Dividend Designation
  - 60 day notice requirement eliminated
  - Retains the requirement to notify shareholders of character of distribution
    - Unlimited flexibility as to timing
    - Additional flexibility as to form of designation (Form 1099's)
  - Effective date – Tax years beginning after 12/22/10
- Observations
  - Not all shareholders receive Form 1099s

Dividend Allocation Rules

[Bill§301 – IRC§852(b)(3); §852(b)(5); §871(k)]

- Allows a non calendar-year RIC to allocate its net capital gain first to reported distribution amounts for the portion of its taxable year ended December 31st
  - Reverts to pro rata allocation if excess reported amounts exceed post-December capital gain dividends
- Similar rules apply for exempt-interest dividends, interest-related dividends, and short-term capital gain dividends
- Observation
  - Reduces the need to file amended Form 1099s

Deferral of Certain Gains and Losses for Excise Tax Purposes

[Bill §402 – IRC§4982(e)]

- Excise tax distribution requirements under §4982
- RIC must distribute 98% of calendar-year ordinary income and 98.2% of capital gain net income computed on 10/31 year
- Recognized in 1986 that capital gain not as predictable as ordinary income
- Similar rules adopted previously for currency gains/losses under §988 and PFIC gains/losses under §1296

Deferral of Certain Gains and Losses for Excise Tax Purposes

[Bill §402 – IRC §4982(e)]

- Excise tax distribution requirements intended to prevent deferral, not to increase total amount RIC must distribute
- But situations arise in which that is the effect
  - RIC may have required excise tax distribution but no e&p to support dividend treatment even if makes the distribution
- RIC Mod addresses both the timing problem for ordinary income/ loss on disposition and "glitches" that can lead to RIC being required to distribute more than its total income
- Effective for calendar year 2011 and thereafter

Deferral of Certain Gains and Losses for Excise Tax Purposes

[Bill §402 – IRC §4982(e)]

- Deferral of Late-Year Gains and Losses
  - The legislation expands the deferral rule applicable to post-October currency and PFIC gains/losses
  - Any "specified gain" or "specified loss" properly taken into account in November and December is treated as arising on January 1 of the next calendar year
  - Specified gain and loss = ordinary gain or ordinary loss from sale, exchange or disposition of property
    - includes gain/loss on terminations
  - Deferral is not elective

Deferral of Certain Gains and Losses for Excise Tax Purposes

[Bill §402 – IRC §4982(e)]

- In addition to foreign currency and PFIC gain/loss, will apply to:
  - market discount recognized on disposition of debt instrument
  - gain on contingent payment debt instrument (Reg. § 1.1275-4)
  - gain on disposition of shares in CFC by 10% U.S. shareholder (§1248)
- "Specified mark-to-market provisions" apply as if 10/31 were last day of RIC's taxable year
- Includes §1256, §1296 and any other Code section or regulation that treats property as disposed of on last day of taxable year

Deferral of Certain Gains and Losses for Excise Tax Purposes

[Bill §402 – IRC §4982(e)]

- Elective Deferral of Pre-January Ordinary Losses
  - Addresses one of the "glitch" situations in which a RIC could be required to distribute more than its net income
  - Example: June 30 RIC has ($50) ordinary loss from 7/31 through 12/31 and then has $50 ordinary income for rest of its taxable year
    - Prior law: excise distribution requirement of $49 in second calendar year even though no net income for TYE 6/30 and no e&p
    - Now RIC can treat the ($50) loss as occurring on 1/1 of second calendar year

Deferral of Late Year Losses

[Bill §308 – IRC §852(b)]

<u>Capital Losses</u>

<u>Current Law – Deferral of net capital losses and net long-term capital losses</u>

Designation – mandatory deferral of either post-October net capital loss or net long-term capital loss

Taxable Income

elective deferral of post-October net capital loss or net long-term capital loss

"bifurcation" adjustments to coordinate income and excise tax rules

Earnings and Profits – current earnings do not include post-October net capital losses

Deferral of Late Year Losses (cont'd)

[Bill §308 – IRC §852(b)]

New Law – Elective Deferral of Post-October Capital Losses

Designation – mandatory deferral is gone

Taxable Income - RIC can defer part or all of **any** post-October capital loss.

post-October capital loss means the greatest of the RIC's net capital loss, net long-term capital loss, **or the net short-term capital loss**

Earnings and Profits

For calendar distributions, post-October net capital losses are excluded

Deferral of Late Year Losses (cont'd)

[Bill §308 – IRC §852(b)]

Example – Impact of removing the mandatory deferral for designation purposes

RIC has a calendar year end

1/1-10/31 STCG $1M, distributed as ordinary in December

11/1-12/31 LTCL ($1M), STCG $1M, therefore no net post-October capital loss

Result

- **Current Law** - Because of the designation rule, defer post-October LTCL and pay $1M STCG
- **New Law** - RIC does not have to defer the post-October LTCL and has no further distribution requirement for its taxable year

Deferral of Late Year Losses (cont'd)

[Bill §308 – IRC §852(b)]

Deferral of Late-Year Ordinary Losses

Current Law - Taxable Income

- elective deferral of **certain** late year ordinary post-October losses
  - foreign currency losses under §988
  - passive foreign investment company losses **to the extent provided in regulations** (regulations have not been issued)
  - contingent payment debt instruments
- there is no deferral of other ordinary losses

Earnings and Profits

- For calendar distributions, only certain post-October ordinary losses are excluded

Deferral of Late Year Losses (cont'd)

[Bill §308 – IRC §852(b)]

New Law - Taxable Income

Coordination with the new excise tax cut-off rules

Can now elect to "push" to the first day of the next taxable year all or part of any **late-year ordinary loss** defined as the excess of

(1) the sum of the **specified** post-October losses and **other post-December ordinary losses**, over

(2) **Specified post-October gains** and **other post-December ordinary gains**

Specified gains and losses have the same meaning as under the excise rules

Earnings and Profits

For calendar distributions, post-October specified losses and post-December other ordinary losses are excluded

Deferral of Late Year Losses (cont'd)

[Bill §308 – IRC §852(b)]

Example

RIC has June Year End and starts 7/1 year 1

7/1-12/31	Ordinary income	$100
December year 1	Ordinary dividend	100
1/1-6/30 year 2	Ordinary loss	(100)

<u>Current Law</u> - No income, no E&P – distribution becomes a ROC

Forms 1099-DIV do not reflect the ROC

Fund owes approximately $4 excise tax

<u>New Law</u> - The ($100) is a late-year ordinary loss

RIC elects to defer the loss to 7/1 year 2

The December year 1 distribution is a dividend and Forms 1099-DIV are correct

Deferral of Late Year Losses (cont'd)

[Bill §308 – IRC §852(b)]

Implementing the new rules - things to be thinking about

- Revise taxable income calculation spreadsheets
- Thoroughly test assumptions to ensure spreadsheets function properly
- Loss deferrals require judgment that was not previously required
  - Build a default assumption into the spreadsheet or develop guiding principles
  - Evaluate review procedures

Other Provisions

- Excise Tax Exemption for RICs with Certain Tax-Exempt Shareholders
  - Expands types of shareholders that can invest in a fund without fund being required to satisfy excise tax distribution requirements
  - [Bill §401 – IRC §4982(f)]
- Excise Tax Treatment of Estimated Tax Payments
  - Expands definition of "distributed amount" to include the amount on which estimated tax is paid
  - [Bill §403 – IRC §4982(c)]
- Increase in Excise Tax Distribution Requirement
  - Increases required distribution for capital gain net income from 98% to 98.2%
  - [Bill §404 – IRC §4982(b)]

Other Provisions

- Deficiency Dividends
  - Repeals penalty (equal to interest charge) on deficiency dividend
  - [Bill§501 – IRC§6697;§860]

- §852(f) Sales Load Basis Deferral
  - Narrows scope of basis adjustment rule for shares purchased with "reinvestment right" (whereby first-purchased shares are redeemed and other shares are acquired without incurring a second sales charge);
  - Cuts off rule's application after January 31 of year following the year in which RIC shares (with reinvestment right) are redeemed after being held for less than 90 days
  - [Bill§502 – IRC§852(f)]

RIC Modernization Act Webinar

- Thank you for attending today's webinar.
- All materials discussed today may be accessed by attendees through ICI's website at conferences.ici.org