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RE: _____
 – Liquidity Fee Tax Issues

Dear Ms. Zarlenga and Mr. Novey:

The Investment Company Institute¹ thanks you for taking the time to meet with us recently to discuss the tax issues arising from the Securities and Exchange Commission (“SEC”) proposal to reform money market funds (the “SEC Release”).² Specifically, we recommended a solution for resolving the liquidity fees to avoid breaking a \$1.00 net asset value (“NAV”).³ Under our proposal, the Treasury Department and the Internal Revenue Service (“IRS”) would deem the fund to have sufficient earnings and profits to distribute any excess liquidity fees, thereby creating an ordinary distribution and avoiding a return of capital.⁴ We ask the

¹The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and other investment vehicles. We are committed to the highest ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, and more than 90 million shareholders.

² See *Money Market Fund Reform; Amendments to Form PF*, SEC Release No. IC-30551 (June 5, 2013).

³ We also discussed IRS Notice 2013-48, which proposes a *de minimis* exception to the wash sale rule for shares in money market funds with a floating net asset value. We will provide comments on the Notice in a separate letter.

⁴ We also discussed a second alternative, in which the fees would be treated as capital gains to the fund when received, under the theory that the fees are being used to offset capital losses incurred by the fund on its portfolio in order to pay the redeeming shareholders. See *Arrowsmith et al v. Commissioner of Internal Revenue*, 344 U.S. 6 (1952); see also Revenue Procedure 2009-10, 2009-1 C.B. 267. If the fees have to be distributed to avoid breaking the \$1.00 NAV, the distributions would be capital gain distributions, rather than returns of capital. The primary concern with this approach is that a fund would be required to distribute the liquidity fees as gains, regardless of their effect on the NAV, unless it has offsetting capital losses. Although a fund likely would have current or prior year losses that it could utilize, in other situations losses might have to be generated to offset the gains. This loss management effort could result in unnecessary transaction costs. Therefore, the deemed earnings and profits approach is the industry’s preferred solution.

Treasury Department and the IRS to provide guidance permitting this solution, should the SEC Release be implemented.

SEC Proposal: Liquidity Fees

The SEC Release proposes two options for reforming money market funds, which could be implemented separately or together. One of these proposals would permit all money market funds to transact at a stable value, but it would require funds in certain circumstances to institute a liquidity fee and would permit them to impose redemption gates in times of stress. The liquidity fee would be imposed if the money market fund's level of weekly liquid assets fell below a certain percentage. The liquidity fee would apply to any redemptions and would equal 2 percent of the gross proceeds, although the fund's board would have discretion to reduce the amount of the fee or to waive the fee altogether.

Current Treatment of Early Redemption Fees

As the SEC Release briefly mentions, the treatment of liquidity fees to funds and shareholders should be the same as the current treatment of early redemption fees pursuant to SEC Rule 22c-2 under the Investment Company Act of 1940. The tax treatment of early redemption fees is well settled. Specifically, receipt of early redemption fees results in no income or gain to the fund under section 311(a)(2). For book purposes, the fee is treated as "paid-in capital." For shareholders who are assessed an early redemption fee, the amount of the fee reduces their amount realized, thereby decreasing any capital gain or increasing any capital loss. The liquidity fee proposed by the SEC is similar in purpose and operation to an early redemption fee; therefore, the same tax analysis should apply.

Potential Returns of Capital

The SEC Release raises one issue that may arise if liquidity fees are imposed. A money market fund could collect enough liquidity fees to push the fund's NAV close to \$1.0050. In such a case, the fund would need to make a distribution to its shareholders to avoid "breaking the buck" on the upside. The distribution would be treated as an ordinary distribution to the shareholders, subject to ordinary income tax rates, if the fund has sufficient earnings and profits to support the distribution. It is more likely, however, that in this scenario the fund would not have sufficient earnings and profits, in which case some or all of the distribution would be a return of capital to the existing shareholders. Shareholders would reduce the basis in their existing shares (*e.g.*, \$1.00 per share in a stable NAV fund) by the amount of the return of capital. Because their basis would now equal something less than \$1.00, those shareholders would have unrealized gains in their money market fund shares. In other words, although the fund's NAV would never vary from a stable \$1.00, the return of capital distribution would cause all existing shareholders in the stable NAV fund to "break the buck" on the upside when they

redeem shares, which is the very position the fund was trying to avoid by making the distribution in the first place.⁵

We believe the likelihood of this scenario is remote; however, it is possible. Thus, funds must be prepared to deal with the situation if it should arise. The Institute believes the best solution for resolving the return of capital issue is to deem the fund to have sufficient earnings and profits to make any distribution resulting from excess liquidity fees. Under this alternative, any distribution would be treated as an ordinary dividend distribution and would not affect the shareholders' basis. During our recent meeting, you asked whether there should be some limit or ceiling on the amount of deemed earnings and profits a fund may have. We believe that money market funds' boards should have discretion to determine how much of the excess liquidity fees they need to distribute. Some funds may decide that they only want to distribute enough to bring the NAV to just under \$1.005; others may decide to distribute enough to bring the NAV closer to \$1.000. Of course, funds should not be deemed to have more earnings and profits than the total amount of liquidity fees collected. We thus suggest that funds be deemed to have earnings and profits equal to the lesser of (i) the total amount of fees collected, or (ii) the total amount of distributions that would reduce the fund's NAV back to \$1.000.

When determining the total amount of fees collected, the amount should be cumulative and not limited to fees collected in a particular time period. These fees are permanent items that will increase the NAV. If a fund must make a distribution to avoid exceeding a NAV of \$1.005, it likely will be due to liquidity fees collected in another year. The cumulative amount of fees received thus should be taken into consideration when determining how much earnings and profits a fund should be deemed to have.

We also ask the government to issue formal guidance setting forth the proper treatment of liquidity fees, clarifying that the liquidity fees are not income or gains to the fund when received. The industry generally believes that this is the correct answer. Given that the government has not provided formal guidance on the treatment of Rule 22c-2 fees, however, some uncertainty remains. Clarification by the Treasury Department and the IRS would provide assurance to the industry that they are accounting correctly for these fees if the SEC moves forward with this proposal.

Tax and Information Reporting

Money market funds that maintain a stable NAV under SEC Rule 2a-7 currently are exempt from information reporting under section 6045.⁶ One question is whether payment of the fee, which effectively is a capital loss to the redeeming shareholder, creates an obligation by the fund to report the

⁵ If the liquidity fees are imposed in conjunction with the floating NAV proposal, the return of capital issue is not a concern with respect to those funds required to have a floating NAV. The shareholders' basis in floating NAV money market funds already might be something other than \$1.00, so a return of capital distribution in and of itself would not necessarily create unrealized gains.

⁶ Treas. Reg. § 1.6045-1(c)(3)(vi).

redemption on IRS Form 1099-B. The same question arises if a money market fund must make a return of capital distribution, which reduces a shareholder's basis below \$1.00. Because the money market fund in these situations still is maintaining a stable NAV under SEC Rule 2a-7, we do not believe any information reporting is required under section 6045 in either scenario. Funds will have other means of communicating this information to their shareholders, either through trade confirmations, quarterly statements, or other shareholder communications. We thus ask the Treasury Department and the IRS to confirm that no information reporting under section 6045 is required in these circumstances.

If the liquidity fees and redemption gates are proposed in conjunction with a floating NAV, and if a Form 1099-B otherwise is required on a floating NAV money market fund, then we ask the Treasury Department and the IRS to clarify that liquidity fees paid by a shareholder must be reflected on the Form 1099-B as a reduction in the amount of gross proceeds.⁷ This would provide consistency across funds and brokers and would assist shareholders in filing their tax returns.

We appreciate your attention to these issues. As you know, timely resolution of the tax issues raised by the SEC's proposals is essential if the reforms are adopted. If you have any further questions or concerns, please contact me at 202-371-5432 or kgibian@ici.org.

Sincerely,



Karen L. Gibian
Associate Counsel – Tax Law

cc: Norm Champ
Director, Division of Investment Management
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⁷ Many investors in floating NAV money market funds will be "exempt recipients" under Treas. Reg § 1.6045-1(c)(3)(i), for which no information reporting is required. Funds and intermediaries should not be required to provide a Form 1099-B to those shareholders simply because a liquidity fee is imposed. The liquidity fee will be disclosed to those shareholders on their transaction confirmations and through other disclosures.

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