

Representatives Rangel and Neal Introduce Bill to Modernize Federal Tax Rules for Regulated Investment Companies

Yesterday, House Ways and Means Committee Chairman Charles B. Rangel (D-NY) and House Select Revenue Measures Subcommittee Chairman Richard Neal (D-MA) introduced legislation, the ["Regulated Investment Company Modernization Act of 2009"](#) (the "Act"), that would modernize various U.S. federal income and excise tax rules relating to mutual funds and other registered investment companies that are regulated investment companies (RICs) under Subchapter M of the Internal Revenue Code (the "Code"). The Act seeks to modify or eliminate various special tax rules applicable to RICs that have become obsolete, as well as to reduce the adverse effects of certain technical tax rules on RICs and their shareholders.

We have been actively involved in efforts to enact these reforms. In its current form, the Act would reduce uncertainties in the application of the current tax laws to RICs and the administrative burdens they impose on RICs and provide RICs with greater flexibility regarding the types of investment strategies in which they may engage. The following summarizes some of the Act's more significant proposals.

I. Modification of Gross Income and Asset Qualification Tests

- **Treat commodities gains as qualifying income.** To qualify as a RIC, at least 90% of a fund's annual gross income must consist of the items specified in Code Section 851(b)(2) ("qualifying income"). The Act proposes to amend Section 851(b)(2) to include commodities gains among the list of sources of qualifying income. This will enable RICs to invest in precious metals and other commodities, including through futures, swaps, and other derivatives contracts.
- **Create a savings provision for gross income test.** Currently, a RIC cannot cure a violation of the gross income test to avoid the loss of its RIC status. The Act 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.
- **Create a savings provision for gross assets tests.** In addition to the gross income test, a RIC must satisfy certain quarterly asset diversification tests under Code Section 851(b)(3). The Act would add to the assets tests' current remedial provisions a savings provision for de minimis asset test failures cured within six months of the failure and a mechanism by which RICs can cure other inadvertent asset test failures and pay a penalty excise tax therefor.

II. Modification of Capital Loss Carryovers of RICs

- The Act proposes to revise the capital loss carryover rules for RICs so that they would follow more closely in a number of respects those currently applicable to individuals. Under the Act, a RIC would be permitted to carry forward its net capital losses without expiration, rather than only for eight years, as under current law, generally effective for losses incurred in taxable years beginning after the date of enactment. This change will lessen the potential tax cost of fund mergers. In addition, very generally, a RIC would retain the character of its net capital losses in subsequent years as short-term or long-term, instead of automatically treating them as short-term capital losses, as under current law.

III. Modification of Rules Related to Dividends and Other Distributions

- **Repeal of the “preferential dividend” rule.** The Act proposes to repeal the preferential dividend rule for publicly offered RICs. The Investment Company Act limitations will continue to apply.
- **Redemptions from publicly offered mutual funds are exchanges.** Under current law, mutual funds can encounter significant difficulties determining whether a distribution in partial redemption of its shares will be treated as a “sale or exchange” under Code Section 302 or as a distribution under Code Section 301, taxed as a dividend. The Act would allow all publicly offered open-end RICs to treat redemptions of their shares as Section 302 exchanges.
- **Return of capital distributions.** The Act provides that, in the case of a non-calendar year RIC which makes distributions in excess of its earnings and profits (E&P) with respect to the taxable year, its current E&P would be allocated first to distributions made on or before December 31 and then to subsequent distributions, instead of the current-law requirement that E&P be allocated pro rata among all distributions made during the taxable year. This proposal will make it easier for non-calendar-year RICs with distributions in excess of E&P to preserve dividend treatment for distributions already reported on Forms 1099.
- **Elimination of dividend designation requirements.** The Act would eliminate the current requirement that a RIC send a written designation notice to its shareholders within sixty days of the end of its taxable year notifying shareholders of the tax treatment of various distributions made during that year. The Forms 1099 would instead serve this notice purpose.
- **Other changes.** The Act contains a number of other technical revisions related to RIC distributions, including establishing an elective deferral of certain late-year losses, modifying the dividend allocation rules for specially designated dividends in order to reduce the need for taxable year RICs to amend Forms 1099, modifying the rules for when a so-called “spillback” dividend must be paid, and correcting the technical glitch under Code Section 852(c)(1) to allow certain disallowed deductions associated with tax-exempt income to be taken into account in calculating a RIC’s E&P.

IV. Modification of Rules Related to Funds of Funds

- **Elimination of loss deferral rules.** When the shareholders of the upper-tier fund in a fund of funds redeem their upper-tier fund shares, requiring redemption by the upper-tier fund of its shares in a lower-tier fund that is a member of the same controlled group of corporations as the upper-tier fund, any loss by the upper-tier fund on the disposition of the lower-tier fund shares may be deferred or potentially permanently disallowed. The Act provides that, except to the extent provided in regulations, this loss deferral rule would not apply to redemptions of shares of an open-end RIC if a redemption is on the demand of a shareholder which is another RIC.
- **Pass through of exempt-interest dividends and foreign tax credits in fund-of-funds structures.** Under current law, if a RIC invests exclusively in shares of other RICs that pass through tax-exempt interest or foreign tax credits, the upper-tier RIC does not meet the 50% requirements imposed by the exempt-interest and foreign tax credit rules and thus cannot separately pass these tax attributes on to its shareholders. The Act would allow an upper-tier RIC that is a qualifying fund of funds (i.e., that invests 95% of its assets in cash and cash items and in other RICs) to pass through the tax-exempt interest and foreign tax credits it receives to its shareholders without regard to the 50% requirements.

V. Other Provisions

The Act also proposes certain technical changes to the RIC excise tax rules, repeals the assessable penalty for deficiency dividends, and limits the application of the sales load basis deferral rule. We had hoped the Act would

contain a proposal permitting RICs to carry forward net operating losses, but understand that that proposal was not included because of its significant cost. Nor does it reconcile the operation of other corporate tax provisions (relating, for example, to the limitation of capital loss carryforwards) with the RIC provisions of Subchapter M.

Because the Act is at an early stage in the legislative process, we cannot predict whether it will be enacted into law or, if enacted, what its final terms will be. We will continue to monitor its status and any related legislative proposals, and provide more detailed analysis and commentary with respect to the proposed legislation as things develop.

You can access the [summary](#) and more detailed [technical explanation](#) of the Act, which the House Ways and Means Committee released yesterday, by clicking [here](#).

For more information on the proposed legislation or any other RIC-related questions, please contact any member of the Tax & Benefits department or the Investment Management practice group; or your usual Ropes & Gray advisor.

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