House and Senate Pass RIC Modernization Act of 2010; Bill Clears for President's Signature

Congress has just passed H.R. 4337, the *Regulated Investment Company Modernization Act of 2010* (the "Act"), which modernizes various U.S. federal income and excise tax rules relating to registered investment companies that are regulated investment companies ("RICs") under Subchapter M of the Internal Revenue Code (the "Code"), whether open-end ("mutual funds") or closed-end. The Act clarifies the current tax laws affecting RICs, modifies or eliminates various special tax rules applicable to RICs that have become obsolete, and reduces the administrative burdens imposed on RICs and the adverse effects of certain technical tax rules on RICs and their shares.

The Act incorporates many substantive proposals included in the original bill as introduced in December 2009 (for Ropes & Gray's alert on the original bill, click here). Notably, the Act does not contain a significant provision included in the original bill that would have treated a RIC's gains from all commodities, rather than only from foreign currencies, as "qualifying income" for purposes of a RIC's gross income test. This provision would have enabled RICs to invest without limitation in precious metals and other commodities, including through futures, swaps, and other derivative contracts. Gains from foreign currency will continue to constitute "qualifying income" unless and until Treasury exercises the regulatory authority it was granted in 1986 to exclude certain foreign currency gains from qualifying income. We have been actively involved in efforts to enact these reforms, and expect efforts to extend good income treatment to all commodities gains to continue next year.

The following summarizes some of the Act's more significant provisions. Please note that the effective dates of the Act's provisions vary. As indicated below, many of the provisions will be effective for a RIC's taxable year beginning after the date of the Act's enactment, but certain provisions offering relief to RICs will be effective for taxable years for which the returns are not yet due.

I. Modification of Gross Income and Asset Qualification Tests

- **New cure provision for good income test.** Currently, a RIC cannot cure a violation of the good income test to avoid the loss of its RIC status. The Act permits a RIC to cure inadvertent failures to comply with the good income test by paying a tax equal to the amount by which the RIC failed the good income test. *Effective for taxable years with respect to which the due date (including any extensions) of the tax return for such taxable year is after the date of enactment.*
- **New cure provision for diversification tests.** In addition to the good income test, a RIC must satisfy certain quarterly asset diversification tests under Code Section 851(b)(3). The Act will add to the diversification tests' current remedial provisions a cure provision for *de minimis* diversification test failures cured within six months of the failure and a mechanism by which RICs can cure other inadvertent diversification test failures, including by paying a penalty excise tax therefor. *Effective for taxable years with respect to which the due date (including any extensions) of the tax return for such taxable year is after the date of enactment.*

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II. Modification of Capital Loss Carryovers of RICs

- **No expiration period.** The Act revises the capital loss carryover rules for RICs so that they more closely follow those currently applicable to individuals. Under the revised rules, a RIC is permitted to carry forward its net capital losses without expiration, rather than only for eight years, as under current law. This change will generally lessen the potential tax cost of fund mergers.
- **Character of loss retained.** A RIC will 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. Because a RIC with capital loss carryovers deriving from long-term capital losses will now be required to use those losses to offset long-term capital gain before short-term capital gain, the RIC may be required to distribute a greater amount of short-term capital gains taxable to shareholders at ordinary income rates than if the RIC were permitted to offset short-term capital gain first. We understand that this provision was included as a revenue raiser in order to keep the Act largely revenue neutral. Ironically, by reducing the value of capital loss carryovers (the use of which is frequently impaired by fund mergers), this change will also lessen the potential tax cost of fund mergers.
- **"Stacking" rule.** The long-term or short-term capital loss described in the previous bullet will be treated as arising on the first day of each taxable year of the RIC to which it is carried forward. The effect of this rule is to require RICs to use net capital losses governed by the new rules (that do not expire) before capital loss carryovers arising prior to the effective date of the Act, and therefore to inhibit a RIC's use of precisely those (pre-Act) losses that will expire.
- *Effective for net capital losses arising in taxable years beginning after the date of enactment.*

III. Modification of Rules Related to Dividends and Other Distributions

- **Repeal of the "preferential dividend" rule for publicly offered RICs.** The Act repeals the preferential dividend rule for publicly offered RICs. The Investment Company Act limitations will continue to apply. Generally, a RIC is "publicly offered" if its shares are continuously offered pursuant to a public offering, regularly traded on an established securities market, or held at all times during the taxable year by or for at least 500 persons. *Effective for distributions in taxable years beginning after the date of enactment.*
- **Redemptions from publicly offered mutual funds are exchanges.** Under current law, RICs 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 to the extent supported by earnings and profits ("E&P"). The Act allows all publicly offered open-end RICs (mutual funds) to treat redemptions of their shares as Section 302 exchanges. *Effective for distributions made after the date of enactment.*
- **Return-of-capital distributions.** The Act provides that, in the case of a non-calendar year RIC which makes distributions in excess of its current E&P with respect to the taxable year, those current E&P will be allocated first to distributions made before January 1 and then to subsequent distributions, instead of being allocated *pro rata* among all distributions made during the taxable year, as is required for all other "C" corporations. This provision makes it easier for non-calendar-year RICs with taxable-year distributions in excess of current E&P to preserve dividend treatment for distributions already reported on Forms 1099. *Effective for distributions made in taxable years beginning after the date of enactment.*

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- **Elimination of dividend designation requirements.** The Act eliminates the current requirement that, within sixty days of the end of its taxable year, a RIC send a written designation notice to its shareholders notifying them of the tax treatment of dividends that pass through the character of certain tax-advantaged income, or related foreign tax credits, during the year. The Forms 1099 will instead serve this notice purpose. *Effective for taxable years beginning after the date of enactment.*
- **Other changes.** The Act contains a number of other technical amendments related to RIC distributions, a number of which have been revised and improved since the original bill was introduced in December 2009. These amendments include (i) additional changes to the allocation rules for dividends that pass through the character of certain tax-advantaged income, in order to reduce the need for non-calendar-year RICs to amend Forms 1099, (ii) easing some of the technical rules relating to the timing of so-called "spillback" dividends, (iii) correcting the technical glitch under Code Section 852(c)(1), so that certain disallowed deductions associated with tax-exempt income reduce a RIC's current E&P and (iv) an elective deferral of certain late-year losses. Under a provision not included in the original bill, the disallowance of a shareholder's loss on RIC shares held for six months or less to the extent of exempt-interest dividends received on the shares does not apply to exempt-interest dividends from most RICS that declare exempt-interest dividends daily.

IV. Modification of Rules Related to Funds of Funds

- **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 dividend and foreign tax credit rules and thus cannot pass these tax attributes on to its shareholders. The Act allows an upper-tier RIC that is a "qualified fund of funds" to pass through the exempt-interest dividends and foreign tax credits it receives to its shareholders without regard to the 50% requirements. A RIC is a "qualified fund of funds" if, at the close of each quarter of its taxable year, at least 50% of its assets consists of interests in other RICs. This definition is more favorable than the definition provided in the original bill introduced in 2009, which required that the RIC invest at least 95% of its assets in cash, cash items and other RICs. *Effective for taxable years beginning after the date of enactment.*
- **Easing of loss deferral rules.** When an upper-tier fund in a fund of funds redeems its shares in a lower-tier fund that is a member of the same controlled group of corporations as the upper-tier fund (i.e., in more-than-50% ownership situations), whether because the upper-tier fund is allocating assets away from the lower-tier fund or because the upper-tier fund is shrinking, 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 will 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. Other loss deferral rules, such as the wash sale rules, will continue to apply as under current law. *Effective for distributions made after the date of enactment.*

V. Other Provisions

The Act also incorporates certain technical changes to the RIC excise tax rules, and increases the percentage of a RIC's capital gain net income (that is, the excess of all capital gains over all capital losses) the RIC must distribute on a calendar-year basis from 98 percent to 98.2 percent for purposes of the excise tax. The increase in the required distribution applies only with respect to capital gain net income; the required

distribution with respect to a RIC's ordinary income remains at 98 percent. These provisions will be effective for calendar years beginning after the date of the Act's enactment. In addition, the Act repeals the assessable penalty for deficiency dividends (effective for taxable years after the date of enactment) and limits the application of the sales-load basis deferral rule (effective for charges incurred in taxable years after the date of enactment).

Several proposals suggested to Congress are not reflected in the Act, most notably, a proposal that would permit RICs to carry forward net operating losses, and a proposal that would treat commodities gains as "qualifying income," described above. We understand that the former proposal was omitted, early on, in order to keep the legislation revenue neutral, and that the latter proposal ran into opposition at the last minute. In addition, it may well be the case that certain provisions of the Act that apply only to publicly offered RICs will eventually be expanded to cover all RICs in the future (e.g., a full repeal of the preferential dividend rule).

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We expect the Act to be largely beneficial to RICs. However, certain of the provisions of the Act will likely raise interpretive issues as such provisions are implemented.

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

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