SUTHERLAND

LEGAL ALERT

December 23, 2010

Revision of RIC Tax Rules

On December 22, 2010, President Obama signed the "Regulated Investment Company Modernization Act of 2010" (the Act). As the name implies, the Act is intended to update many of the tax rules applicable to regulated investment companies (RICs). The changes made by the Act will give RICs more flexibility in their investment decisions and make it less likely that a RIC will inadvertently fail to qualify for RIC tax treatment under the Internal Revenue Code (the Code). In addition, the Act simplifies many of the procedural and reporting requirements applicable to RICs, simplifies the calculation of the federal excise tax on undistributed earnings of RICs, and conforms the treatment of RICs to the treatment of real estate investment trusts (REITs) in a number of respects. The Act is generally revenue neutral and is expected to be beneficial to most RICs. The provisions of the Act will apply to 2011 and subsequent taxable years.

The most significant changes made by the Act include the following:

- **Preferential dividend rule repealed for publicly offered RICs.** Under section 852(b) of the Code, RICs generally are allowed to deduct from their investment company income and net capital gains any dividends paid to shareholders. However, this deduction is not allowed if a RIC pays any "preferential dividends." This preferential-dividend rule generally requires that (i) all dividends be paid pro rata among all holders of the same class of shares, so that all members of the class are treated equally and (ii) all preferences among classes of shares be respected. Although the preferential-dividend rule may prevent shareholders of certain privately held RICs from manipulating their respective shares of a RIC's earnings, such manipulation is highly unlikely to occur in the case of publicly offered RICs. In the context of publicly offered RICs, the IRS generally has interpreted the preferential dividend rule in a manner intended to protect investors by ensuring that all similarly situated shareholders are treated equally. Because the protection of shareholders of publicly offered securities is generally within the domain of the Securities and Exchange Commission, however, and because the Investment Company Act of 1940 contains its own shareholder protection provisions, the preferential-dividend rule generally is unnecessary to protect shareholders in publicly offered RICs. Accordingly, the preferential-dividend rule as applied to publicly offered RICs largely had become a trap exposing those RICs to potential adverse tax treatment as a result of inadvertent processing or computational errors. To eliminate this potential trap, the Act repeals the preferential-dividend rule with respect to publicly offered RICs. The preferential-dividend rule will continue to apply to privately held RICs.

- **Provides a savings provision for certain failures to satisfy the gross income or asset diversification tests.** RICs generally must derive 90% of their gross income each taxable year from certain income sources designated under section 851(b)(2) of the Code. In addition, under section 851(b)(3), a RIC must satisfy certain asset diversification tests as of the end of each quarter of its taxable year. Under prior law, if a RIC failed to comply with the gross income requirement or the asset diversification requirements, it ceased to qualify for RIC tax treatment and became subject to tax as an ordinary corporation. In the case of REITs, which are subject to similar income and asset diversification tests and generally are taxed in a similar manner to RICs, the Code contains certain provisions that allow a REIT to cure certain inadvertent failures to comply with these tests without losing its qualification as a REIT. To conform the treatment of RICs and REITs, the Act generally provides similar rules to allow RICs to cure inadvertent failures to comply with the gross income and asset diversification tests.

- In the case of a failure to comply with the gross income test, a RIC may avoid disqualification if such failure was due to reasonable cause and not willful neglect by providing the IRS with a description of each item of its gross income that caused such failure and paying a tax equal to the amount by which the RIC's "bad" RIC income exceeds 1/9th of its "good" RIC income.

- In the case of a failure to satisfy the diversification tests, the Act provides two different methods to cure the failure, depending upon whether or not the failure is considered de minimis.

    - If the failure is considered de minimis (defined as the lesser of 1% of the total value of the RIC's assets at the end of the relevant quarter or $10,000,000), the RIC can avoid disqualification by disposing of the assets causing such failure or otherwise coming into compliance with the diversification tests within six months of the end of the quarter in which it identified the failure.

    - If the failure is not considered de minimis, a RIC can avoid disqualification if the failure is due to reasonable cause and not willful neglect by providing a schedule of the nonqualifying assets to the IRS, disposing of the nonqualifying assets or otherwise coming into compliance with the diversification tests within six months of the end of the quarter in which it identified the failure, and paying a tax equal to the greater of (i) $50,000 or (ii) an amount equal to the highest corporate tax rate times the net income derived from the "bad" assets during the period of failure.

- **Repeals the penalty applicable to certain deficiency dividends.** A RIC can distribute a "deficiency dividend" with respect to a prior taxable year in the event it is determined that the RIC did not distribute enough income or capital gains for such year to avoid an income tax liability. Such a deficiency dividend is deductible for purposes of determining the RIC's tax liability for the year to which the deficiency dividend relates. Although the payment of the deficiency dividend can eliminate the RIC's liability for tax for the year, the RIC still is subject to an interest charge on the tax that would have been due. In addition, under prior law, a RIC was subject to an "additional penalty" equal to the lesser of (i) the amount of the interest charge or (ii) 50% of the amount of the deficiency dividend. REITs may also pay deficiency dividends, but they are not subject to the additional penalty. To conform the treatment of RICs and REITs, the Act eliminates the additional penalty on RICs. The interest charge continues to apply to both RICs and REITs.

- **Provides for pass-through of exempt-interest dividends and foreign tax credits in fund-of-funds structures.** A RIC is allowed to pass through to its shareholders the benefit of (i) any tax-exempt interest by paying exempt-interest dividends, provided that at least 50% of the RIC's assets are comprised of tax-exempt bonds and (ii) any foreign tax credits, provided that more than 50% of the RIC's assets are comprised of stock or securities in foreign corporations. Under prior law, these ownership requirements applied to upper-tier funds in "fund-of-funds" structures. As a result, even if a lower-tier fund in such a structure met the requirements to pass through such tax items, the upper-tier fund might not have been able to pass through those items to its shareholders. The Act allows the upper-tier fund in fund-of-funds structures to pass through the exempt-interest dividends and foreign tax credits allowed with respect to the lower-tier fund or funds, provided that 50% or more of the upper-tier fund's assets consist of interests in other RICs.

- **Modifies the dates for declaring and paying spillover dividends.** Under prior law, certain dividends (referred to as "spillover dividends") paid by a RIC after the end of its taxable year may be taken into account in computing the RIC's dividends-paid deduction for such year, provided that such dividends were declared by the due date for filing the RIC's tax return for the taxable year and the dividends were paid to shareholders within the 12 months following the end of such year (but not later than the date of the first "regular dividend" paid by the RIC after declaration). The Act modifies the period for declaring a spillover dividend by allowing such dividend to be declared by the later of the 15th day of the ninth month following the close of the taxable year or the extended due date of the return for such taxable year. The Act also eliminates the requirement that the spillover dividend be paid no later than the first regular dividend following the declaration and instead provides that the spillover dividend must be paid no later than the first dividend payment of the same type of dividend (e.g., ordinary dividend or capital gain dividend).

- **Unlimited carryforwards of capital losses.** Under prior law, RICs were prohibited from carrying back capital losses, but generally could carry forward capital losses for eight taxable years. In contrast, individuals are entitled to unlimited carryforwards of capital losses. Because RICs generally are intended to provide individual investors with a means of collectively investing their money in a manner that is, from a federal tax perspective, consistent with the treatment of individual investments, the Act brings the treatment of loss carryforwards by RICs in line with the treatment accorded individual investors by allowing an unlimited carryforward of capital losses. Prior law will continue to apply, however, to capital loss carryforwards arising in taxable years beginning before the date of enactment.

In addition to these provisions, the Act includes a number of provisions intended to simplify RIC reporting and administrative requirements. In this respect, the Act:

- Eliminates the requirement to provide a separate written designation of the tax characteristics of certain distributions (e.g., capital gain dividends or tax-exempt interest dividends) apart from the IRS Form 1099 reporting requirements.

- Provides relief from the requirement to file amended IRS Form 1099s for distributions reported as capital gains prior to the close of a RIC's taxable year when the RIC recognizes capital losses after December 31 of a taxable year, by allowing the RIC first to reduce the amount of capital gain dividends in the subsequent year.

- Allows a RIC that has a taxable year other than the calendar year to elect to treat a post-December 31 loss (or, in the case of capital gains, a post-October 31 loss) as arising on the first day of the RIC's subsequent taxable year.

- Allows certain non-deductible expenses associated with tax-exempt income to reduce earnings and profits in order to eliminate dividend taxation of certain distributions that economically are a return of capital.

- Provides that, in the case of a RIC that has a taxable year other than the calendar year, the RIC's current earnings and profits will first be allocated to distributions made on or before December 31 of the taxable year to eliminate the risk that certain distributions intended to reduce or eliminate excise tax would be treated as return of capital distributions as a result of allocating current earnings and profits across all distributions made during the taxable year.

- Generally treats all redemptions of shares of publicly offered RICs that are redeemable upon demand as exchanges, which eliminates the possibility that such redemptions may constitute dividends.

- Eliminates the application of certain loss-deferral rules when a lower-tier fund in a fund-of-funds structure redeems its shares held by the upper-tier fund.

- In the case of certain RICs that declare exempt-interest dividends on a daily basis, provides an exception to holding period requirements that otherwise must be satisfied in order to avoid the disallowance of losses realized on the sale or exchange of shares of the RICs.

- Expands the categories of tax-exempt entities that may own a RIC without causing such RIC to become subject to the excise tax on undistributed earnings.

- Expands the types of ordinary gains and losses (including foreign currency gains and losses) that may be treated as arising in the next calendar year solely for excise tax purposes.

The only revenue offset provided in the Act is attributable to a slight increase in the amount of capital gains that must be distributed each calendar year to avoid the excise tax on undistributed earnings. Under prior law, a RIC was required to distribute to its shareholders each calendar year the sum of (1) 98% of its net ordinary income for each calendar year, (2) 98% of its capital gain net income for the one-year period ending October 31 in that calendar year and (3) any income recognized, but not distributed, in preceding years and on which no federal income tax was paid. The Act increases the amount of the capital gain net income that must be included in this determination to 98.2% (i.e., a 0.2% increase).

The Act is substantially similar to a prior version of the Act that was passed by the House of Representatives on September 28, 2010. The only significant difference is that the prior version included a provision that would have treated income from direct investments in commodities as "good" RIC income for purposes of the 90% gross income test under section 851(b)(2) of the Code. This provision was eliminated from the Act as ultimately passed by both chambers of Congress. As a result, under current

IRS rulings, income from direct investments in commodities will continue to be "bad" RIC income under section 851(b)(2) of the Code. Based on other rulings by the IRS, RICs currently may obtain exposure to investments in commodities through certain structured notes or investments in foreign corporations treated as controlled foreign corporations for U.S. federal tax purposes. The Act does not affect the tax treatment of these alternative investment structures.

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If you have any questions about this Legal Alert, please feel free to contact either of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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