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Regulated Investment Company Modernization Act of 2010

Summary: The bill, signed into public law on December 22, 2010, streamlines and updates technical tax rules with the objective of correcting inefficiencies, and addressing unintended tax consequences relating to the previous law governing the taxation of regulated investment companies (“RICs”).

Background. An investment company registered under the Investment Company Act of 1940, as amended, may elect to be taxed as a RIC, under the provisions of Subchapter M of the Internal Revenue Code, for any taxable year in which it satisfies certain requirements relating to the source of its income and the diversification of its assets. Corporations that elect to be treated as RICs under Subchapter M of the Internal Revenue Code will be considered a pass-through entity that acts as a partial conduit to its shareholders, with respect to income and gains it earns. This conduit treatment is achieved because a RIC is permitted to deduct distributions of ordinary income and long-term capital gains to its shareholders in computing the RIC’s taxable income, which generally results in no income tax liability to the RIC. Under Subchapter M, the RIC also has the ability to pass through to its shareholders the character of certain types of income such as tax-exempt income, qualified dividend income, long-term capital gain, and dividends eligible for the corporate dividends received deduction. In addition, the RIC has the capability to pass through foreign tax credits to its shareholders, and designate net short-term capital gains and U.S.-source interest income to foreign shareholders. RICs have become one of the most popular investment vehicles, mainly due to favorable tax attributes and simplified tax reporting to shareholders.

Key Provisions. The Regulated Investment Company Modernization Act of 2010 (“Act”) makes the most comprehensive changes to RIC tax law since the Tax Reform Act of 1986. The Act addresses unintended tax consequences that became evident due to technical application of the prior law. These were a “laundry list” of items that produced tax inequities over the years, which the mutual fund industry had unsuccessfully lobbied Congress to correct. The Act also seeks to improve and promote efficiencies in different types of fund structures, such as funds-of-funds. One important item that was originally included in the Act was a commodities provision, which would have permitted RICs to generate income directly from commodities-based assets without jeopardizing their Subchapter M RIC tax status. However, this commodities provision did not make the final version of the Act.

Thought Leadership Update

By

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Overall, the Act is viewed as beneficial to RICs and their shareholders since its purpose is to correct many of the inconsistencies that existed under the prior law. However, the Act has the potential to create new concerns since several new provisions require clarification.

The Act contains provisions that can be grouped into four main categories:

- Modification to Capital Loss Carryovers
- Gross Income and Asset Diversification Rules
- Items affecting the Distribution Rules
- Miscellaneous Items

Modification to Capital Loss Carryovers

- Permits a RIC to carry forward, without limit, net capital losses generated for taxable years beginning after the date of enactment. For capital loss carryovers that originated prior to the Act becoming effective, the old rules are still applicable, meaning that any such unutilized capital loss carryovers will expire in eight years.

Gross Income and Asset Diversification Rules

- The Act allows relief for inadvertent Gross Income Test failures. The prior law did not have a cure provision.
- The Act also allows additional relief to existing mitigation provisions for Gross Asset Test failures. The Act provides additional relief for two categories of failure; de minimis and non-de minimis failures.

Items affecting the Distribution Rules

- Elimination of the 60-day designation requirements for capital gain dividends and other designated items. The new provision allows for items "to be reported on any written statement furnished to all shareholders.
- Repeal of the preferential dividend rule for publicly offered RICs. Under prior law, a dividend that was considered to be preferential would not be deductible in calculating a RIC's taxable income.
- Modifications to the calculation of a RIC's earnings and profits.
- Pass-through of exempt-interest dividends and foreign tax credits in a fund-of-funds structure.
- Modification of rules as to the declaration and payment of spillover dividends.
- Sale/exchange treatment of distributions in redemption of a RIC's stock.
- Elective deferral of certain late-year ordinary losses.
- New rules allowing for "true" post-October loss deferrals, including short-term capital losses.

- Exception to the holding period requirement for certain regularly declared exempt-interest dividends.
- Deferral of certain gains and losses of regulated investment companies for excise tax purposes.
- Increase in the excise tax distribution requirement for capital gain net income to 98.2%.

Miscellaneous Items

- Excise tax exemption for certain RICs owned by tax-exempt entities.
- Distributed amount for excise tax purposes determined on estimated taxes paid by RIC.
- Repeal of additional penalty on payment of deficiency dividends.
- Modification of sales load basis deferral rule.

The Act's provisions are generally effective for RIC tax years beginning after the date of enactment.

Status and Interpretative Guidance

The mutual funds industry has requested guidance and clarification with respect to certain provisions of the Act. Specifically, the industry has requested that the IRS and Treasury issue guidance providing that:

- The capital loss carry-forward provision of the Act is effective for purposes of the calendar year 2011 excise tax calculation under section 4982 of the Internal Revenue Code;
- The "bifurcation" rules of Notice 97-64, as modified by Notice 2004-39, continue to apply to the extent necessary to prevent the re-characterization of capital gain dividends; and
- RICs may satisfy the "written statement" requirements of the Act regarding the character of certain dividends by posting the information on their public websites.

The industry is currently awaiting a response from the IRS/Treasury.



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