

PART 1 — INDUSTRY COMMENTARY

The RIC Modernization Act: Status, Implications and Impact

By Elisabeth M. Martinetz

On September 30 to October 3, the **Investment Company Institute** (the "ICI") hosted their 2012 Tax and Accounting Conference in Orlando, Florida. It was my privilege to participate on the conference's "Current Tax Developments" panel and update attendees on the status of the Regulated Investment Company Modernization Act (the "Act"). As we move forward with the implementation of the Act, it is important that the mutual fund industry have a full understanding of its implications and impact.



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In late December 2010, the Act was signed into law and became effective for tax years beginning after December 22 of that year. Bringing long-awaited reform for the mutual fund industry, the Act brought about the most comprehensive changes to mutual fund tax law since the Tax Reform Act of 1986. Before the Act, the Industry had unsuccessfully lobbied Congress to address the tax inequities that arose from the application of the prior law. The Act's provisions give a mutual fund more flexibility in managing distributions. It also provides relief alternatives for unintentional failures to meet the requirements to be a regulated investment company ("RIC") which affords shareholders certain beneficial tax treatment. The provisions of the Act can be grouped into three main categories: relief for gross income and asset diversification failure, amendments to the distribution rules and miscellaneous amendments.

SUBCHAPTER M QUALIFICATION

Under prior law, if a RIC failed the quarterly asset diversification test it had a thirty-day window to cure the failure. If not cured in a timely manner the only alternative would be to request a private ruling from the **Internal Revenue Service** (the "Service"), which is costly and

not guaranteed. The Act provides additional relief for two categories of failure: *de minimis* and non-*de minimis*. There is still a cost involved for a non-*de minimis* failure, but that cost certainly outweighs the negative impact a failure would have on a fund and its shareholders if relief were not available. The Act also amends the rules for gross income test failures; previously, there was no self-cure for a failure except to request a private ruling from the Service.

DISTRIBUTION RULES

The Act makes numerous improvements to the distribution rules. Some of the more noteworthy ones include: repeal of the preferential dividend rule for publicly traded RICs that otherwise would disallow treating the preferential amount as a dividend received deduction; dividend pass-through of foreign tax credits and tax-exempt interest for qualifying fund-of-fund structures; and rules to minimize the number of situations where a RIC would need to send revised 1099s due to distribution reallocations.

MISCELLANEOUS AMENDMENTS

The Act also includes amendments to (a) remove the limitation on capital loss carryovers, (b) modify the definition of a post-October capital loss to allow deferral of losses only, including a short-term loss, (c) allow elective, partial deferrals of such capital losses; and (d) expand deferral treatment to certain ordinary losses.

ADDITIONAL GUIDANCE

Most of the provisions can be clearly interpreted; however, some bring new uncertainty that tax professionals are trying to understand and practically apply. The ICI has requested guidance from the Service and Treasury on two issues. The first request is whether prior bifurcation guidance can be relied upon to address certain distribution inconsistencies that were not fully considered in the Act. The second request is whether a company's

website meets the written statement requirement for reporting capital gain dividends and other distributions. As of this writing, the Service and Treasury have not yet issued guidance on these two requests.

These are not the only provisions with which tax professionals are grappling. As the Industry continues to discern and implement the provisions, mutual fund companies and service providers are working with the ICI to obtain clarification and guidance on the technical application and long-term implications of the Act.

The Act allows more flexibility than ever before, with increased opportunities for professional judgment and interpretation. Some of this flexibility has a direct impact on distributions to shareholders such as the option to defer certain capital and ordinary losses, or the pass through of exempt interest dividends or foreign tax credits for qualified fund-of-fund shareholders. Your tax professional should be knowledgeable about the Act in order to be able to provide the information you need to make the best decisions for your RIC and its shareholders.

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