

House Passes RIC Modernization Act of 2010

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On September 28, the U.S. House of Representatives passed the Regulated Investment Company (RIC) Modernization Act of 2010 (the Act), which will go a long way toward updating and streamlining a number of mutual fund tax rules. It may be premature, however, to start celebrating. No companion bill is currently pending in the Senate, so the Act's prospects remain uncertain. On the upside, the Act is viewed as noncontroversial and, as a result of a slight tweak to the excise tax rules to increase the required distribution for capital gain net income of a RIC from 98% to 98.2%, it is now a revenue raiser. Following is an overview of some of the more significant changes that would arise if the Act is passed by the Senate in its current form and signed into law.

Income from Transactions in Commodities Would Be Qualifying Income. Currently, income from certain transactions in commodities is not treated as "qualifying income" for purposes of the RIC qualification requirement that 90% of a RIC's gross income constitute "qualifying income." The Act would provide that income from commodities and commodities-linked derivatives would be counted as qualifying income. This change, however, doesn't mean that the workarounds of commodities-linked notes and controlled foreign corporations (CFCs) that currently offer RICs exposure to commodities should be put aside. RICs will still need to meet the asset diversification requirements with respect to their investments in "securities," and commodities are not considered "securities" for these purposes. Open questions remain as to whether derivatives based on commodities are "securities" under the Internal Revenue Code's (IRC's) cross-reference to the Investment Company Act of 1940 (1940 Act) for purposes of defining what constitutes a "security" for these purposes.

Form 1099 to Replace 60-Day Designation Rules. Currently, a RIC must designate the character of certain of its dividends not later 60 days after the close of its taxable year. These requirements predate the requirement that a RIC send a Form 1099 to shareholders. The Act would replace the 60-day designation requirements with a requirement that these designations be made by means of a written statement to shareholders that would include Form 1099.

Clarification of Foreign Currency Gains. Currently, the U.S. Department of the Treasury (the Treasury) has the authority to promulgate regulations to exclude from qualifying income certain foreign currency gains that are not directly related to a RIC's principal business of investing in stock and securities. To date, however, no such regulations have been issued. The Act would remove the Treasury's authority to issue these regulations, thereby clarifying a RIC's ability to invest in foreign currencies.

Repeal of Preferential Dividend Rules for Publicly Offered RICs. Currently, RICs are subject to the preferential dividend rules. Under these rules, the dividends paid deduction is not available to a RIC unless, generally, the dividends it pays are paid pro rata with no preference to any shares of stock, except to the extent a class of stock is entitled to a preference. The Act would repeal the application of the antiquated preferential dividend rules as they apply to RICs and, as a result, would remove an area of considerable uncertainty and traps for the unwary.

Capital Loss Carryforwards. Currently, capital loss carryforwards are limited to eight years. Under the Act, losses would be carried forward indefinitely and retain their character as either short-term or long-term losses.

More Forgiving Penalties for RIC Qualification Missteps. Currently, some minor RIC qualification missteps might result in complete qualification failure for a RIC. The Act would provide for certain cures for failures due to reasonable cause and certain *de minimis* failures. These failures would generally be able to be cured with monetary penalties (with a minimum penalty of \$50,000, similar to what is currently available for REIT qualification failures).

Pass-Through of Exempt Interest Dividends and Foreign Tax Credits for Certain RIC Fund of Funds. Fund of funds structures have become more common, but there exist some definitional restraints in the IRC regarding the pass-through of exempt interest dividends and foreign tax credits. The Act would permit the pass-through of these items through fund of funds. In addition, certain loss deferral provisions of the IRC would not apply to redemptions of lower-tier RICs in these structures.

Redemptions of Open-End RIC Shares. Currently, there is some uncertainty concerning the treatment of the redemption of open-end RIC shares regarding whether certain redemptions are to be treated as dividends or are to be treated as sale or exchange transactions, depending on the circumstances. The Act would provide that the redemption of stock of certain publicly offered RICs be treated as a sale or exchange transaction if the redemption is on the demand of the shareholder.

Spillback Dividends. Currently, some antiquated rules govern the timing of the declaration and distribution of spillback dividends. The Act would permit flexibility regarding their declaration and distribution.

Increase in Excise Tax Distributions. As a pay-for, the Act would provide an increase in the required distribution for capital gain net income of a RIC from 98% to 98.2%. For a number of reasons, such as late Form K-1s or other tardy information, a number of RICs end up paying excise taxes (usually in a *de minimis* amount). Interestingly, the change was made only with respect to capital gain net income; the required distribution amount with respect to a RIC's ordinary income remains at 98%.

Other Proposed Changes in the Act:

- Modification of rules for allocating certain RIC capital gain dividend distributions
- Inclusion of certain nondeductible items of RIC income in earnings and profits calculations for tax-exempt funds
- Permission of the deferral of certain end-of-year losses of RICs
- Modification of certain return of capital distributions of RICs
- Deferral of certain gains and losses of RICs for excise tax purposes
- Determination of distributed amount for excise tax purposes on the basis of taxes paid by the RIC

- Repeal of certain deficiency dividend penalties for RICs
- Modification of sales load basis deferral rules for RICs

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