

President Obama Signs RIC Modernization Act of 2010

December 23, 2010

On December 22, President Obama signed into law the Regulated Investment Company Modernization Act of 2010 (the Act). The Act includes almost all of the provisions of the version of the legislation passed by the U.S. House of Representatives on September 28, 2010, except for the provisions dealing with a mutual fund's ability to invest in commodities and certain provisions related to investments in foreign currencies. The effective date for most of the changes contained in the Act is for taxable years beginning after the date of enactment. The following is an overview of some of the more significant changes contained in the Act.

Form 1099 to Replace 60-Day Designation Rules. Under prior law, a registered investment company (RIC) was required to designate the character of certain of its dividends not later than 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 replaces the 60-day designation requirements with a requirement that these designations be made by means of a written statement to shareholders that, based on the legislative history, includes Form 1099.

Repeal of Preferential Dividend Rules for Publicly Offered RICs. Under prior law, RICs were subject to the preferential dividend rules. Under those rules, the dividends-paid deduction was not available to a RIC unless, generally, its dividends were 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 repeals the application of the antiquated preferential dividend rules as they apply to publicly traded RICs and, as a result, removes an area of considerable uncertainty and traps for the unwary.

Capital Loss Carryforwards. Under prior law, capital loss carryforwards were limited to eight years. Under the Act, losses will be carried forward indefinitely and retain their character as either short-term or long-term losses. Transition rules are introduced that dictate the timing regarding the utilization of existing carryforwards with the newly permitted carryforwards under the Act.

More Forgiving Penalties for RIC Qualification Missteps. Under prior law, some minor RIC qualification missteps might result in complete qualification failure for a RIC. The Act provides for certain cures for failures due to reasonable cause and for certain de minimis failures. These failures will be generally 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 Funds of Funds. Fund of funds structures have become more common, but prior law imposed some definitional

restraints in the Internal Revenue Code (IRC) regarding the pass-through of exempt interest dividends and foreign tax credits. The Act permits the pass-through of these items through funds of funds. In addition, certain loss-deferral provisions of the IRC no longer apply to redemptions of lower-tier RICs in these structures.

Redemptions of Open-End RIC Shares. Under prior law, there was some uncertainty concerning the treatment of the redemption of open-end RIC shares regarding whether certain redemptions were to be treated either as dividends or as sale or exchange transactions, depending on the circumstances. The Act provides 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. Under prior law, some antiquated rules govern the timing of the declaration and distribution of spillback dividends. The Act permits more flexible rules regarding the declaration and distribution of spillback dividends.

Increase in Excise Tax Distributions. As a pay-for, the Act provides 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 often 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 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

Provisions Dropped from the Act by the Senate

Income from Transactions in Commodities and Certain Foreign Currency Investments. 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 legislation passed by the House would have provided that income from commodities and commodities-linked derivatives would count as qualifying income and clarified investment by RICs in foreign currencies. Some Senators reportedly had reservations regarding the consequences of these provisions and requested further study and consideration of them. Such provisions were dropped from the legislation to permit the prompt approval of the other provisions where there was agreement. It is unclear at this point whether these provisions will be reconsidered.

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