

# Congress Modernizes the Taxation of Regulated Investment Companies

*James Hamilton, J.D., LL.M.  
Principal Analyst*



## Introduction

Congress has passed bipartisan legislation amending the Internal Revenue Code so that provisions affecting SEC-regulated investment companies will better conform to, and interact with, other aspects of the Code and applicable federal securities laws. The Regulated Investment Company Modernization Act of 2010, [H.R. 4337](#), would reduce the burden arising from amended year-end tax information statements, improve a mutual fund's ability to meet its distribution requirements, create remedies for inadvertent mutual fund qualification failures, improve the tax treatment of investments in a fund-of-funds structure, and update the tax treatment of fund capital losses.

Specifically, the legislation:

- Creates a special rule allowing unlimited carryovers of the net capital losses of regulated investment companies
- Exempts regulated investment companies from loss of tax-preferred status and additional taxes for failure to satisfy the gross income and assets tests if that failure is *de minimis* and is due to reasonable cause and not willful neglect
- Revises the definitions of “capital gain dividend” and “exempt-interest dividend” for purposes of the taxation of funds and their shareholders to require that dividends be reported to shareholders in written statements
- Excludes net capital losses of funds from earnings and profits
- Prohibits earnings and profits from being reduced by any amount that is not allowable as a deduction in computing taxable income, except with respect to a net capital loss
- Allows a qualified fund of funds to pay exempt-interest dividends and allow its shareholders the foreign tax credit without regard to certain requirements that the fund of funds invest in state and local bonds or foreign securities
- Modifies rules for dividends paid by funds after the close of a taxable year (so-called spillover dividends)
- Revises the method for allocating fund earnings and profits to require those earnings and profits to be allocated first to distributions made prior to December 31 of a calendar year
- Allows funds with shares that are redeemable on demand to treat distributions in redemption of stock as an exchange for income-tax purposes

- Repeals preferential dividend rules for funds that are publicly offered
- Allows funds to elect to treat a post-October capital loss and any late-year ordinary loss as arising on the first day of the following taxable year
- Exempts from holding-period requirements regular dividends paid by a fund that declares exempt-interest dividends on a daily basis in an amount equal to at least 90 percent of its net tax-exempt interest and distributes those dividends at least monthly
- Extends the exemption from excise tax of failure to distribute taxable income of a fund to other tax-exempt entities with an ownership interest in a fund
- Allows specified gains and losses of a fund derived after October 31 to be deferred, for excise-tax purposes, until January 1 of the following calendar year
- Creates a special rule for estimated excise-tax payments of funds
- Increases from 98 percent to 98.2 percent the amount of capital gain net income funds must distribute
- Repeals the additional penalty on funds for tax deficiencies for which a deficiency dividend has been distributed

The House passed the legislation by a voice vote on September 28, 2010. The Senate passed the bill by unanimous consent on December 8, 2010. Because the Senate passed the legislation with an amendment (the Bingaman Amendment stripping out Sec. 201 on fund commodities investments), H.R. 4337 returned to the House and, on December 15, 2010, the House agreed to the Senate Amendment and sent the legislation to the President, who is expected to sign it.

The legislation would modernize federal tax code provisions governing mutual funds that have not been updated in any meaningful or comprehensive way since the adoption of the Internal Revenue Code of 1986. Some of the provisions date back more than 60 years. Numerous developments during the past two decades, including the development of new fund structures and distribution channels, have placed considerable stress on the current tax code sections.

In general, regulated investment companies under the Code are domestic corporations that: (1) either meet SEC registration requirements under the Investment Company Act of 1940 or are excepted common trust funds under Investment Company Act Section 3(c)(3); (2) derive at least 90 percent of their ordinary income from passive investment income; and (3) have a portfolio of investments that meet certain diversification

requirements. Regulated investment companies under the Code can be either open-end companies (mutual funds) or closed-end companies.

The incoming chair of the House Ways and Means Committee, Rep. Dave Camp (R-Mich.), strongly supports the complete legislative overhaul of federal tax code provisions affecting investment companies. Noting that he is not aware of any controversy or opposition to the legislation, Rep. Camp emphasized that it is entirely appropriate for Ways and Means to periodically review the tax law to ensure that targeted provisions of importance to particular segments of the economy, including mutual funds and their investors, are kept up to date. [*Cong. Record* (Sept. 28, 2010), p. H7069-7070]

## Capital Loss Carryovers

Currently, losses from the sale or exchange of capital assets are allowed only to the extent of the taxpayer's gains from the sale or exchange of capital assets plus, in the case of a taxpayer other than a corporation, \$3,000. Under the Code, if an investment company has a net capital loss for any taxable year, the amount of the net capital loss is a capital loss carryover to each of the eight taxable years following the loss year, and is treated as a short-term capital loss in each of those years. The entire amount of a net capital loss is carried over to the first taxable year succeeding the loss year, and the portion of the loss that may be carried to each of the next seven years is the excess of the net capital loss over the net capital gain income (determined without regard to any net capital loss for the loss year or taxable year thereafter) for each of the prior taxable years to which the loss may be carried.

In the case of a corporation other than an investment company, a net capital loss generally is treated as a capital loss carryback to each of the three taxable years preceding the loss year and a capital loss carryover to each of the five taxable years following the loss year, and is treated as a short-term capital loss in each of those years. The carryover amount is reduced in a manner similar to that described above applicable to investment companies. A net capital loss cannot be carried back to a taxable year for which a corporation is an investment company.

If an individual taxpayer has a net capital loss for any taxable year, any excess of the net short-term capital loss over the net long-term capital gain is treated as a short-term capital loss in the succeeding taxable year, and the excess of the net long-term capital loss over the net short-term capital gain is treated as a long-term capital loss in the succeeding taxable year. There is no limitation on the number of taxable years that a net capital loss may be carried over.

The legislation provides capital loss carryover treatment for investment companies similar to the treatment currently applicable to individuals. Under the Act, if a fund has a net capital loss for a taxable year, the excess of the net short-term capital loss over the net long-term capital gain is treated as a short-term capital loss arising on the first day of the

next taxable year, and the excess of the net long-term capital loss over the net short-term capital gain is treated as a long-term capital loss arising on the first day of the next taxable year. There is no limit under the provision to the number of taxable years that a fund's net capital loss may be carried over.

The legislation provides for the treatment of net capital loss carryovers under the present Code rules for taxable years of a fund beginning after the date of enactment. These rules apply to capital loss carryovers from taxable years beginning on or before the date of enactment and capital loss carryovers from other taxable years prior to the taxable year when the corporation became an SEC-regulated investment company.

Amounts treated as a long-term or short-term capital loss arising on the first day of the next taxable year under the provision are determined without regard to amounts treated as a short-term capital loss under the present-law carryover rule. In determining the amount by which a present-law carryover is reduced by capital gain net income for a prior taxable year, any capital loss treated as arising on the first day of the prior taxable year under the provision is taken into account in determining capital gain net income for the prior year.

**Example:** Assume a calendar-year fund has no net capital loss for any taxable year beginning before 2010; a net capital loss of \$2 million for 2010; a net capital loss of \$1 million for 2011 (all of which is a long-term capital loss); and \$600,000 gain from the sale of a capital asset held less than one year on July 15, 2012. For 2012, the fund has: (1) a \$600,000 short-term capital gain from the July 15 sale; (2) a \$2 million carryover from 2010 that is treated as a short-term capital loss; and (3) a \$1 million long-term capital loss from 2011 treated as arising on January 1, 2012.

The capital loss allowed in 2012 is limited to \$600,000, the amount of capital gain for the taxable year. For purposes of determining the amount of the \$2 million net capital loss that may be carried over from 2010 to 2013, there is no capital gain net income for 2012 because the \$600,000 gain does not exceed the \$1 million long-term loss treated as arising on January 1, 2012. Therefore, the entire 2010 net capital loss is carried over to 2013 and treated as a short-term capital loss in 2013. \$400,000 (the excess of the \$1 million long-term capital loss treated as arising on January 1, 2012, over the \$600,000 short-term capital gain for 2012) is treated as a long-term capital loss on January 1, 2013. The 2010 net capital loss may continue to be carried over through 2018, subject to reduction by capital gain net income; no limitation applies on the number of taxable years that the 2011 net capital loss may be carried over.

The provision generally applies to net capital losses for taxable years beginning after the date of enactment. The provision relating to the treatment of present-law carryovers applies to taxable years beginning after the date of enactment.

## Savings Provisions for Failure to Meet Gross Income and Assets Test

At the close of each quarter of the taxable year, at least 50 percent of the value of a fund's total assets must be composed of cash and cash items (including receivables), government securities and securities of other funds, and other securities, generally limited in respect of any one issuer to an amount not greater than five percent of the value of the fund's total assets and not more than 10 percent of the issuer's outstanding voting securities.

In addition, at the close of each quarter of the taxable year, not more than 25 percent of the value of a fund's total assets may be invested in: (1) the securities—other than government securities or the securities of other funds—of any one issuer; (2) the securities—other than the securities of other funds—of two or more issuers that the taxpayer controls and that are determined, under Treasury regulations, to be engaged in the same, similar or related trades or businesses; or (3) the securities of one or more qualified publicly traded partnerships.

A fund meeting both asset tests at the close of any quarter will not lose its status as an SEC-regulated investment company because of a discrepancy during a subsequent quarter between the value of its various investments and the asset-test requirements, unless this discrepancy exists immediately after the acquisition of any security or other property and is the result of the acquisition.

This rule is designed to protect a fund against inadvertent failures of the asset tests that may be caused by fluctuations in the relative values of its assets. A second rule gives a fund 30 days following the end of a quarter in which it fails an asset test to cure the failure, if the failure is because of a discrepancy between the value of its various investments and the asset-test requirements that exists immediately after the acquisition of any security or other property and that is the result of the acquisition during that quarter. Failure of any asset test (except where the failure is cured within the 30-day period) will prevent a corporation from qualifying as an SEC-regulated investment company.

A fund must also derive 90 percent of its gross income from qualifying income. Thus, a fund meets the gross-income test if its gross income that is not qualifying income does not exceed one-ninth of the portion of its gross income that is qualifying income. For example, a fund with \$90x of gross income from qualifying income can have up to \$10x of gross income from other sources without failing the test. Failure to meet the gross-income test for a taxable year prevents a corporation from qualifying as an SEC-regulated investment company.

The legislation provides a special rule for *de minimis* asset-test failures and a mechanism by which a fund can cure other asset-test failures and pay a penalty tax. The rule for *de*

*de minimis* asset-test failures applies if a fund fails to meet one of the asset tests in Code Section 851(b)(3) due to the ownership of assets the total value of which does not exceed the lesser of \$10 million or one percent of the total value of the fund's assets at the end of the quarter for which the assets are valued. Where the *de minimis* rule applies, the fund must nevertheless be considered to have satisfied the asset tests if, within six months of the last day of the quarter in which the fund identifies that it failed the asset test the fund disposes of sufficient assets or otherwise meets the requirements of the asset tests. In the case of other asset-test failures, a fund will nevertheless be considered to have met the asset tests if: (1) the fund provides in a schedule filed in the manner prescribed by Treasury a description of each asset that causes the fund to fail to satisfy the asset test; (2) the failure to meet the asset tests is due to reasonable cause and not due to willful neglect; and (3) within six months of the last day of the quarter in which the fund identifies that it failed the asset test, the fund disposes of the assets that caused the asset-test failure or otherwise meets the requirements of the asset tests.

In cases of asset-test failures other than *de minimis* failures, the legislation imposes a tax in an amount equal to the greater of \$50,000 or the amount determined by multiplying the highest rate of tax specified in Code Section 11 by the net income generated during the period of asset-test failure by the assets that caused the fund to fail the asset test. For purposes of subtitle F, the tax imposed for an asset-test failure is treated as excise tax with respect to which the deficiency procedures apply. These provisions added by the Act do not apply to any quarter in which a corporation's status as an SEC-regulated investment company is preserved under present law.

The legislation provides that a fund that fails to meet the gross-income test must nevertheless be considered to have satisfied the test if the failure is due to reasonable cause, not willful neglect, and if the fund provides in a schedule a description of each item of its gross income. In addition, a tax is imposed on any fund that fails to meet the gross-income test. The amount of the tax equals the amount by which the fund's gross income from sources that are not qualifying income exceeds one-ninth of its gross income from sources that are qualifying income.

For example, if a fund has \$90x of gross income of sources that are qualifying income and \$15x of gross income from other sources, a tax of \$5x is imposed. The tax is the amount by which the \$15x gross income from sources that are not qualifying income exceeds the \$10x permitted under present law. Taxes imposed for failure of the asset or income tests are deductible for purposes of calculating investment company taxable income.

These savings provisions apply to taxable years with respect to which the tax return's due date (determined with regard to extensions) falls after the enactment date.

## Modification of Dividend Distribution Rules

Generally, under the Code, a capital gain dividend paid by a fund is treated by the fund's shareholders as a long-term capital gain. In addition, a fund is allowed a dividend-paid deduction for its capital gain dividends in computing the tax imposed on its net capital gain. A capital gain dividend is any dividend, or part thereof, which is designated by the fund as a capital gain dividend in a written notice mailed to the shareholders within 60 days of the close of the fund's taxable year, except that, in the event a fund designates an aggregate amount of capital gain dividends for a taxable year that exceeds the fund's net capital gain, the portion of each distribution that is a capital gain dividend is only that proportion of the designated amount that the fund's net capital gain bears to the total amount so designated by the fund.

**Example:** Assume a fund makes quarterly distributions of \$30, designated entirely as capital-gain dividends. If the fund has only \$100 of net capital gain for its taxable year, only \$25 of each quarterly distribution is a capital-gain dividend.

A fund may designate any portion of a dividend other than a capital-gain dividend as an "exempt-interest dividend" if at least half of the fund's assets consist of tax-exempt state and local bonds. The shareholder treats an exempt-interest dividend as an item of tax-exempt interest.

Exempt-interest dividends are defined as any dividend, or part thereof, which is designated by the fund as an exempt-interest dividend in a written notice mailed to the fund's shareholders within 60 days after the close of the fund's taxable year, except that, in the event a fund designates an aggregate amount of exempt-interest dividends for a taxable year that exceeds the fund's tax exempt interest, the portion of each distribution that will be an exempt-interest dividend is only that proportion of the designated amount that net exempt interest bears to the amount so designated.

Funds may pass through to shareholders certain foreign tax credits, credits for tax-credit bonds and dividends received by the fund that qualify, in the case of corporate shareholders, for the dividends received deduction, or, in the case of individual shareholders, the capital gain rates in effect for dividends received in taxable years beginning before January 1, 2011. In each case, the qualifying amount must be designated in a written notice mailed to the fund's shareholders not later than 60 days after the close of the fund's taxable year.

Dividends paid to non-resident alien individuals and foreign corporations in taxable years of the fund beginning before January 1, 2010, retain their character as interest or short term-capital gain. These dividends must be designated in a written notice mailed to shareholders within 60 days after the close of the fund's taxable year. Rules similar to those described above relating to capital gain dividends and exempt-interest dividends apply to designated amounts in excess of actual amounts.



The legislation, in Section 301, replaces the present-law designation requirement for a capital gain dividend with a requirement that a capital gain dividend be reported by the fund in a written statements furnished to its shareholders. A written statement furnishing this information to a shareholder may be a Form 1099.

The legislation provides a special rule allocating the excess reported amount for taxable-year funds in order to reduce the need to amend Form 1099s and for shareholders to file amended income tax returns. This special allocation rule applies to a taxable year of a fund that includes more than one calendar year if the fund's post-December reported amount exceeds the excess reported amount for the taxable year.

**Example:** Assume a fund for its taxable year ending June 30, 2012, makes quarterly distributions of \$30,000 on September 30, 2011, December 31, 2011, March 31, 2012 and June 30, 2012, and reports the amounts as capital gain dividends. If the fund has only \$100,000 net capital gain for its taxable year, the excess reported amount is \$20,000. Because the post-December reported amount (\$60,000) exceeds the excess reported amount (\$20,000), the excess reported amount is allocated among the post-December reported capital gain dividends in proportion to the amount of each such distribution reported as a capital gain dividend.

Thus, one half of the excess reported amount is allocated to each post-December distribution, reducing the amount of each post-December distribution treated as a capital gain dividend from \$30,000 to \$20,000. Because no excess reported amount is allocated to either of the quarterly distributions made on or before December 31, 2011, the entire \$30,000 of each of the distributions retains its character as a capital gain dividend.

If, in the above example, the fund has only \$40,000 net capital gain for its taxable year, the excess reported amount is \$80,000. Because the post-December reported amount (\$60,000) does not exceed the excess reported amount (\$80,000), the excess reported amount is allocated among all the reported capital gain dividends for the taxable year in proportion to the amount of each distribution reported as a capital gain dividend. Thus, one fourth of the excess reported amount, \$20,000, is allocated to each distribution, reducing the amount of each distribution treated as a capital gain dividend from \$30,000 to \$10,000.

The legislation replaces the other designation requirements under present law with a requirement that amounts be reported by the fund in written statements furnished to its shareholders. Note that the Act does not change the method of designation of undistributed capital gain taken into account by shareholders under Code Section 852(b)(3)(D)(i).

The Act also provides allocation rules for excess reported amounts of exempt-interest dividends and certain dividends paid to nonresident alien individuals and foreign

corporations by fiscal year funds similar to the rule described above applicable to capital gain dividends.

Section 301 applies to taxable years beginning after the date of enactment.

## Fund Earnings and Profits

The current earnings and profits of a fund are not reduced by any amount that cannot be deducted in computing taxable income for the taxable year. Thus, under the general rule, the current earnings and profits of a fund are not reduced by a net capital loss either in the taxable year the loss arose or in any taxable year to which the loss is carried. The accumulated earnings and profits are reduced in the taxable year during which the net capital loss arose.

Because the general rule denies deductions in computing current earnings and profits for amounts disallowed for expenses, interest and amortizable bond premiums relating to tax-exempt interest, the current earnings and profits of a fund with tax-exempt interest may exceed the amount that the fund can distribute as exempt-interest dividends. Thus, distributions by a fund with only tax-exempt interest income may result in taxable dividends to the fund's shareholders.

**Example:** Assume a fund has \$1 million gross tax-exempt interest, \$10,000 expenses disallowed under Code Section 265, no accumulated earnings and profits, and no other item of current earnings and profits. If the fund were to distribute \$1 million to its shareholders during its taxable year, \$990,000 may be designated as exempt-interest dividends and the remaining \$10,000 would be taxable as ordinary dividends.

Under Section 302 of the Act, the rules applicable to the taxable income treatment of a net capital loss of a fund apply for purposes of determining earnings and profits. Thus, a net capital loss for a taxable year is not taken into account in determining earnings and profits, but any capital loss treated as arising on the first day of the next taxable year is taken into account in determining earnings and profits for the next taxable year.

Also, the deductions disallowed in computing investment company taxable income relating to tax-exempt interest are allowed in computing current earnings and profits of a fund. In the example under present law, the provision reduces the fund's current earnings and profits from \$1 million to \$990,000 and if the fund were to distribute \$1 million to its shareholders during the taxable year, \$990,000 could be reported as exempt-interest dividends and the remaining \$10,000 would be treated as a return of capital or gain to the shareholder.

Section 302 applies to taxable years beginning after the date of enactment.

## Pass-Through Rules for Funds of Funds

In a fund-of-funds structure, one fund, called the upper-tier fund, holds stock in one or more lower-tier funds. Generally, the character of certain types of income and gain, such as capital gain and qualified dividends, of a lower-tier fund pass through from the lower-tier fund to the upper-tier fund and then pass through to the shareholders of the upper-tier fund. Exempt-interest dividends and foreign tax credits may be passed through by a fund only if at least 50 percent of the value of the fund's total assets consists of tax-exempt obligations or more than 50 percent of the value of the total assets consists of securities in foreign corporations.

Because an upper-tier fund holds stock in other funds, it does not meet the 50-percent asset requirement. As a result, the fund cannot pass through exempt-interest dividends and foreign tax credits to its shareholders, even though the items were passed through to it by a lower-tier fund meeting these requirements.

Section 303 of the legislation provides that a "qualified fund of funds" may pay exempt-interest dividends without regard to the requirement that at least 50 percent of the value of its total assets consists of tax-exempt state and local bonds, and may elect to allow its shareholders the foreign tax credit without regard to the requirement that more than 50 percent of the value of its total assets consists of securities in foreign corporations. For this purpose, the Act defines "qualified fund of funds" as a fund at least 50 percent of the value of the total assets of which, at the close of each quarter of the taxable year, is represented by interests in other funds.

Section 303 applies to taxable years beginning after the date of enactment.

## Spillover Dividends

A fund may elect to have spillover dividends paid after the close of a taxable year considered as having been paid during that year for purposes of the distribution requirements and for determining the fund's taxable income. To qualify as a spillover dividend, the dividend must be declared prior to the time prescribed for filing the tax return for the taxable year and the distribution must be made in the 12-month period following the close of the taxable year and not later than the date of the first dividend payment made after the declaration.

Section 304 provides that the time for declaring a spillover dividend is the later of the 15th day of the ninth month following the close of the taxable year or the extended due date for filing the return. Also, the requirement that the distribution be made not later than the date of the first dividend payment after the declaration is changed. The statute provides that the distribution must be made not later than the date of the first dividend payment of the same type of dividend made after the declaration. For this purpose, a dividend attributable to short-term capital gain with respect to which a notice is required

under the Investment Company Act must be treated as the same type of dividend as a capital gain dividend. Investment Company Act Section 19 requires notice to shareholders identifying the source of a distribution.

Section 304 applies to distributions in taxable years beginning after the date of enactment.

## Return of Capital Distribution

Under the Code, a dividend is a distribution of property by a corporation out of its earnings and profits accumulated after February 28, 1913, and out of its earnings and profits of the taxable year. The current earnings and profits are prorated among current year distributions. Distributions of property that are not a dividends reduce the adjusted basis of a shareholder's stock and are treated as gains to the extent they exceed the stock's adjusted basis.

**Example:** Assume a fund with a taxable year ending June 30 and with no accumulated earnings and profits has current earnings and profits of \$4 million and distributes \$3 million to its shareholders on September 15 and \$3 million on March 15. Under present law, \$2 million of each distribution is out of current earnings and profits and is treated as dividend income to the shareholders. The remaining amounts are applied against the adjusted basis of each shareholder's stock or taken into account as gain by the shareholders.

The legislation provides that, in the case of a non-calendar-year fund that makes distributions of property with respect to the taxable year in an amount in excess of the current and accumulated earnings and profits, the current earnings and profits are allocated first to distributions made on or before December 31 of the taxable year.

Thus, under Section 305 of the Act, in the above example, all \$3 million of the distribution made on September 15 is out of current earnings and profits and thus treated as dividend income. Only \$1 million of the distribution made on March 15 is out of current earnings and profits and treated as dividend income. The remaining \$2 million of the March 15 distribution is applied against the adjusted basis of each shareholder's stock or taken into account as gain by the shareholders. In the case of a fund with more than one class of stock, the provision applies separately to each class of stock.

Section 305 applies to distributions made in taxable years beginning after the date of enactment.

## Redemption of Stock

The redemption of stock by a corporation is treated under the Code as an exchange of stock if the redemption fits into one of four categories of transactions. If the redemption does not fit into one of these categories, it is treated as a distribution of property.

One of the four categories includes transactions in which the redemption is not essentially equivalent to a dividend. This occurs when a redemption results in a meaningful reduction in the shareholder's proportionate ownership in the company. The other categories include substantially disproportionate redemptions, redemptions that terminate the shareholder's interest in the company, and partial liquidations if the redeemed shareholder is not a corporation. The Code provides no specific rule regarding the application of the "not essentially equivalent to a dividend" test in the case of a mutual fund whose shareholders "sell" their shares by having them redeemed by the issuing fund and where multiple redemptions by different shareholders may occur daily.

Any deduction in respect of a loss from the sale or exchange of property between members of a controlled group of corporations is deferred until the transfer of the property outside the group. In the case of a fund of funds, a lower-tier fund may have to redeem shares in an upper-tier fund when the upper-tier fund shareholders demand redemption of their shares. Because the upper-tier fund and lower-tier fund may be members of the same controlled group of corporations, any loss by the upper-tier fund on the disposition of the lower-tier fund shares may be deferred.

Section 306 of the legislation provides that, except to the extent provided in regulations, the redemption of stock of a publicly offered fund is treated as an exchange if the redemption is on the demand of the shareholder and if the company issues only stock that is redeemable on the shareholder's demand. A publicly offered fund is a fund the shares of which are continuously offered pursuant to a public offering, regularly traded on an established securities market, or held by no fewer than 500 persons at all times during the taxable year.

The legislation provides that, except to the extent provided in regulations, the loss deferral rule does not apply to any redemption of stock of a fund if the fund issues only stock that is redeemable on the shareholder's demand and the redemption is on the demand of a shareholder that is another fund.

Section 306 applies to distributions after the date of enactment.

## Repeal of Preferential Dividend Rule

Funds are allowed a deduction for dividends paid to their shareholders. In order to qualify for the deduction, a dividend must not be a preferential dividend. For this purpose, a

dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference. A distribution by a fund to a shareholder whose initial investment was \$10 million or more is not treated as preferential if the distribution is increased to reflect the reduced administrative cost of the fund with respect to the shareholder. Investment Company Act Section 18 strictly limits the ability of funds to issue shares with preferences.

Section 307 of the Act repeals the preferential dividend rule for publicly offered funds. For this purpose, a fund is publicly offered if its shares are continuously offered pursuant to a public offering, regularly traded on an established securities market, or held by no fewer than 500 persons at all times during the taxable year.

Section 307 applies to distributions in taxable years beginning after the date of enactment.

## Elective Deferral of Late Year Losses

In general, a fund may pay a capital gain dividend to its shareholders to the extent of its net capital gain for the taxable year. The shareholders treat capital gain dividends as long-term capital gain. Under present law, an excise tax is imposed on a fund for a calendar year equal to four percent of the excess of the required distribution over the distributed amount. The required distribution is the sum of 98 percent of the fund's ordinary income for the calendar year and 98 percent of the capital gain net income for the one-year period ending October 31.

The distributed amount is the sum of the deduction for dividends paid during the calendar year and the amount on which a corporate income tax is imposed on the fund for taxable years ending during the calendar year. Currently, for purposes of determining the amount of a net capital gain dividend, the amount of net capital gain for a taxable year is determined without regard to any net capital loss or net long-term capital loss attributable to transactions after October 31 of the taxable year, and the post-October net capital loss or net long term capital loss is treated as arising on the first day of the fund's next taxable year. To the extent provided in regulations, the above rules relating to post-October net capital losses also apply for purposes of computing taxable income of a fund.

Treasury regulations allow funds to defer all or part of any net capital loss attributable to the portion of the taxable year after October 31 to the first day of the succeeding taxable year. [See Treas. Reg. §1.852-11]

No special rule applies to short-term capital losses arising after October 31 of the taxable year for purposes of defining a capital gain dividend.

Under present law, shareholders receive Forms 1099 for 2010 reporting the dividends as other than capital gain dividends, and they report the dividends accordingly on their 2010 income tax returns.

**Example:** If a fund has only \$1 million of current earnings and profits for its taxable year, the fund cannot pay an additional distribution designated as a capital gain dividend for its taxable year in order to be allowed a dividend-paid deduction in computing the fund's tax on net capital gain. Instead, the fund could designate the December 15 distribution as a capital gain dividend, but that would require shareholders to file amended income tax returns for 2010.

Under present law, for purposes of determining capital gain dividends, the push forward of post-October capital losses is automatic, rather than elective. In contrast, however, the push forward of these losses is elective for fund taxable income purposes.

**Example:** Assume that a fund has no net capital gain for the portion of its taxable year on or before October 31 and makes no distributions before January 1 of the taxable year. For the remainder of its taxable year, the fund has a \$1 million short-term capital gain and a \$1 million long-term capital loss. Under present law, for purposes of determining the amount of capital gain dividends, the \$1 million long-term capital loss is automatically pushed forward to the next taxable year. However, for purposes of determining its taxable income, the capital loss is pushed forward only if the fund so elects. If no election is made and the fund has a \$1 million long-term capital gain in the next taxable year and pays a \$1 million dividend, the dividend cannot be designated a capital gain dividend, although the fund had a \$1 million long-term capital gain that year. If an election is made, the fund must distribute the \$1 million of short-term capital gain as an ordinary dividend in the current taxable year, although the gains were economically offset by the long-term capital loss.

In applying the excise tax described above, net foreign currency losses and gains and ordinary losses or gains from the disposition of stock in a passive foreign investment company properly taken into account after October 31 are pushed to the following calendar year for purposes of the tax. Under present law, to the extent provided in regulations, a fund may elect to push the post-October net foreign currency losses and the net reduction in the value of stock in a passive foreign investment company with respect to which an election is in effect under Code Section 1296(k) forward to the next taxable year. Regulations have been issued allowing funds to elect to defer all or part of any post-October net foreign currency losses for the portion of the taxable year after October 31 to the first day of the next taxable year. [See Treas. Reg. §1.852-11]

Other fund ordinary losses cannot be pushed forward. As a result, in the event that a fund has net ordinary losses for the portion of the taxable year after December 31, the fund may have insufficient earnings and profits to pay a dividend during the calendar year ending in the taxable year in order to reduce or eliminate the excise tax.

**Example:** Assume a fund for its taxable year ending June 30, 2012, has ordinary income of \$1 million for the portion of its taxable year ending on December 31, 2011. In order to avoid the excise tax, the fund distributes \$980,000 on December 15, 2011. The fund has no accumulated earnings and profits. For the period beginning January 1, 2012 and ending on June 30, 2012, the fund has a net ordinary loss of \$1 million. Because the fund has no earnings and profits, the distribution in 2011 is not a dividend, the distributed amount for calendar year 2011 is zero, and an excise tax is imposed.

The legislation allows a fund to elect to push to the first day of the next taxable year part or all of any post-October capital loss. The post-October capital loss means the greatest of the fund's net capital loss, net long-term capital loss or net short-term capital loss. The election applies for all purposes of the Code, including determining taxable income, net capital gain, net short-term capital gain, and earnings and profits.

**Example:** The application of the provision to short-term capital losses may be illustrated by the following scenario. Assume a fund for its taxable year ending June 30, 2012, recognizes a short-term capital gain of \$1 million on September 15, 2011. To avoid the excise tax, the fund distributes \$980,000 on December 15, 2011. On May 15, 2012, the fund recognizes a \$1 million long-term capital gain and \$1 million short-term capital loss. The fund has no other income or loss during 2011, 2012 or 2013 (and has no accumulated earnings and profits).

The fund may elect to treat the short-term capital loss as arising on July 1, 2012, make an additional \$1 million distribution before July 1, 2012, report the distribution as a capital gain dividend and be allowed a dividends paid deduction in computing the tax on its net capital gain for the 2011–2012 taxable year. No amended Forms 1099 and no amended tax returns by the shareholders would be required.

The legislation also allows a fund to elect to push to the first day of the next taxable year part or all of any qualified late-year ordinary loss. The qualified late year ordinary loss is the excess of the sum of the specified losses attributable to the portion of the taxable year after October 31 and other ordinary losses attributable to the portion of the taxable year after December 31 over the sum of the specified gains attributable to the portion of the taxable year after October 31 and other ordinary income attributable to the portion of the taxable year after December 31.

Section 308 applies to taxable years beginning after the date of enactment.

## Exception to Holding Period

If a fund shareholder receives an exempt-interest dividend with respect to a share of fund stock held for six months or less, any loss on the sale or exchange of the stock, to the



extent of the amount of the exempt-interest dividend, is disallowed. To the extent provided by regulations, the loss disallowance rule does not apply to losses on shares that are sold or exchanged under a plan that involves the periodic liquidation of the shares. In the case of a fund that regularly distributes at least 90 percent of its net tax-exempt interest, Treasury may adopt regulations setting a shorter holding period of at least 31 days or the period between the regular distributions, whichever is greater.

Section 309 of the legislation makes the loss disallowance rule inapplicable, except as otherwise provided by regulations, with respect to a regular dividend paid by a fund that declares exempt-interest dividends on a daily basis in an amount equal to at least 90 percent of its net tax-exempt interest and distributes the dividends at least monthly.

Section 309 applies to stock for which the taxpayer's holding period begins after the date of enactment.

## Distribution Excise Tax

An excise tax is imposed on a fund for a calendar year equal to four percent of the excess of the required distribution over the distributed amount. The required distribution is the sum of 98 percent of the fund's ordinary income for the calendar year and 98 percent of the capital gain net income for the one-year period ending October 31. The distributed amount is the sum of the deduction for dividends paid during the calendar year and the amount on which a corporate income tax is imposed on the fund for taxable years ending during the calendar year. The excise tax does not apply to a fund for a calendar year if, at all times during the calendar year, each fund shareholder is either a qualified pension plan exempt from tax or a segregated asset account of a life insurance company held in connection with variable contracts.

The legislation adds to the list of persons who may hold stock in a fund that is exempt from the excise tax those tax-exempt entities whose ownership of beneficial interests in the fund would not preclude the application of Code Section 817(h)(4) regarding segregated asset accounts of a variable annuity or life insurance contract. These persons include qualified annuity plans described in Section 403, IRAs, including Roth IRAs, certain government plans described in Section 414(d) or 457, and pension plans described in Section 501(c)(18). Also, another fund to which Section 4982 does not apply may hold stock in a fund exempt from the excise tax.

Section 401 applies to calendar years beginning after the date of enactment.

## Deferral of Gains and Losses for Excise Tax

Currently, special rules apply to certain items of income and loss in computing the excise tax under Code Section 4982. Any foreign currency gains and losses attributable to a

Section 988 transaction properly taken into account after October 31 of any calendar year generally are pushed to the following calendar year. Any post-October positive or negative adjustments, and income or loss, on contingent payment debt instruments is treated in the same manner as foreign currency gain or loss from a Section 988 transaction. Also, any gain recognized under Section 1296 relating to marked-to-market for marketable stock in a passive foreign investment company generally is determined as if the fund's taxable year ends October 31, and any gain or loss from an actual disposition of stock in an electing passive foreign investment company after October 31 generally is pushed to the following calendar year.

To the extent provided in regulations, any net foreign currency loss of a fund and any net reduction in the value of the stock of a passive foreign investment company held by a fund attributable to transactions after October 31 of the taxable year may be pushed to the first day of the following taxable year for purposes of computing taxable income. Similar rules apply for purposes of computing earnings and profits in order to allow a fund a distribution deduction for purposes of the excise tax.

The legislation expands the present excise tax push rules applicable to foreign currency gains and losses are to include all specified gains and losses, such as ordinary gains and losses from the sale, exchange or other disposition of property, including foreign currency gain and loss, and amounts marked to market under Section 1296. Thus, these post-October 31 gains and losses are pushed to the next calendar year.

The legislation also provides that, for purposes of determining a fund's ordinary income, the present rule treating the stock of a passive foreign investment company as disposed of on October 31 is made applicable to all property held by a fund that under any provision of the Code is treated as disposed of on the last day of the taxable year.

In addition, for purposes of the excise tax, the Act allows a taxable-year fund to elect to push any net ordinary loss attributable to the portion of the calendar year that is after the beginning of the taxable year that begins in such calendar year to the first day of the next calendar year.

**Example:** Assume a fund for its taxable year ending June 30, 2012, has an ordinary loss of \$1 million for the portion of its taxable year ending on December 31, 2011, and \$1 million ordinary income for the remainder of the taxable year. The fund has no other items of income or loss in 2011, 2012 or 2013. The fund must distribute \$980,000 in 2012 to avoid the excise tax, notwithstanding that it has no taxable income (or earnings and profits) for a taxable year that includes any portion of 2012. Under the provision, if the fund makes an election, the \$1 million ordinary loss will be treated as arising on January 1, 2012, for purposes of the excise tax and the fund will not have to make a distribution in 2012 to avoid the excise tax.

Section 402 applies to calendar years beginning after the date of enactment.

## Determining Distributed Amount

In computing the excise tax under Code Section 4982, a fund is treated as having distributed amounts on which a tax is imposed on the fund during the calendar year in which the taxable year of the fund ends, regardless of the calendar year in which estimated tax payments are made. Under Section 403, a fund making estimated tax payments of the taxes imposed on investment company taxable income and undistributed net capital gain for a taxable year beginning (but not ending) during any calendar year may elect to increase the distributed amount for that calendar year by the amount on which the estimated payments of these taxes are made during that calendar year. The distributed amount for the following calendar year is reduced by the amount of the prior year's increase.

Section 403 applies to calendar years beginning after the date of enactment.

## Increase in Capital Gains Distribution

An excise tax is imposed on a fund for a calendar year equal to four percent of the excess of the required distribution over the distributed amount. The required distribution is the sum of 98 percent of the fund's ordinary income for the calendar year and 98 percent of the capital gain net income for the one-year period ending October 31. The distributed amount is the sum of the deduction for dividends paid during the calendar year and the amount on which a corporate income tax is imposed on the fund for taxable years ending during the calendar year. The legislation increases the required distribution percentage of the capital gain net income from 98 percent to 98.2 percent. Section 404 applies to calendar years beginning after the date of enactment.

## Repeal of Penalty

A fund with a tax deficiency with respect to a prior taxable year can distribute a deficiency dividend, which is treated by the fund as a dividend paid with respect to the prior taxable year. As a result, the deficiency dividend increases the fund's deduction for dividends paid for that year and eliminates the deficiency. A fund making a deficiency dividend is subject to an interest charge as if the entire amount of the deficiency dividend were the amount of the tax deficiency. Currently, an additional penalty is also imposed equal to the lesser of the amount of the interest charge or one half of the amount of the deficiency dividend. The legislation repeals the additional penalty with respect to deficiency dividends.

Section 501 applies to taxable years beginning after the date of enactment.

## Commodities

An SEC-regulated investment company must derive 90 percent of its gross income for a taxable year from certain types of income, called qualifying income, which includes gains from the sale or other disposition of securities as defined in Investment Company Act Section 2(a)(36) or foreign currencies or other income derived with respect to the business of investing in those securities or currencies. In general, because direct investments in commodities are not securities under Section 2(a)(36) they do not generate qualifying income for purposes of the 90-percent gross-income test. Similarly, the IRS has ruled that derivative contracts with respect to commodity indices are not securities for the purposes of the gross-income tests.

The House version of H.R. 4337 would have changed the qualifying income test to provide that gains from the sale or other disposition of commodities are qualifying income for purposes of the gross-income test. As a result, income earned by an investment company from derivative contracts with respect to commodity indices would have been qualifying income. However an amendment offered by Senator Jeff Bingaman (D-NM), and approved by the Senate, stripped out this provision. □

## About the Author

**James Hamilton** is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information and a prolific blogger (Jim Hamilton's World of Securities Regulation, at <http://jimhamiltonblog.blogspot.com>). Hamilton has been tracking, analyzing and explaining securities law and regulation for over 30 years as an analyst for CCH/Wolters Kluwer. He has written and spoken extensively on federal securities law and is cited as an authority in the Senate Banking Committee Report (S. 111-176) of the Dodd-Frank Act. His analysis of that legislation, the *Dodd-Frank Wall Street Reform and Consumer Protection Act: Law, Explanation and Analysis*, is widely read. His earlier analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules*, is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law*, the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.

If you would like to post this white paper on your firm's intranet site, please contact Randy Kaplan at [randy.kaplan@wolterskluwer.com](mailto:randy.kaplan@wolterskluwer.com) or call 212-771-0866.

We welcome any and all inquiries to share or republish this material.

**Visit our FREE Website – the CCH<sup>®</sup> Financial Reform News Center**  
*for continuing coverage of events and legislation related to the financial crisis*

Updated daily by a team of CCH attorney-editors, the site includes news and analysis; links to source documents, government agencies and major publications; and access to additional related content for CCH subscribers.

Sign up for this free service via RSS feed or email subscription.

[View Now](#)