RIC Modernization Act of 2010

President Signs Legislation Designed to Simplify and Update the Rules Relating to Regulated Investment Companies

SUMMARY
On Wednesday, December 22, 2010, the President signed into law the Regulated Investment Company Modernization Act of 2010, H.R. 4337 (the “Act”). The Act does not include the provision of previously proposed legislation that would have treated gains from investing in commodities as qualifying income for purposes of the income test that must be met by a regulated investment company (a “RIC”), but does make a number of changes that are intended to modernize the tax laws governing RICs, including the following:

- Repeal of the “preferential” dividend rule for publicly offered RICs;
- Elimination of the current eight-year limit on the use of capital loss carryforwards and allowance of RIC capital losses to carry forward indefinitely as either short-term losses or long-term losses;
- Remedial provisions similar to those available to real estate investment trusts for failures to satisfy the gross income or gross asset tests;
- The pass-through of exempt-interest dividends and foreign tax credits in fund-of-fund structures;
- The inapplicability of the loss deferral rules for sales among members of a controlled group of corporations to certain redemptions of RIC stock in fund-of-fund structures;
- Clarification that redemptions by publicly-traded RICs of shares redeemable upon demand are sales or exchanges, not dividends; and
- Extension of the class of tax-exempt shareholders that may hold shares of a RIC that is exempt from the excise tax imposed on RICs.

BACKGROUND RELATING TO RICS
To qualify as a RIC, an electing corporation must, among other things, (i) meet (or be excepted from) certain registration requirements under the Investment Company Act of 1940, (ii) derive at least 90% of its gross income from certain specified sources, such as interest, dividends and gains from sales of securities, and (iii) satisfy certain asset diversification tests. A RIC is not subject to federal income tax on
the income and gain that it distributes to shareholders as dividends, provided that it distributes at least 90% of its investment company taxable income and net tax exempt interest income for the year.\(^1\) Additionally, a 4% excise tax (the “RIC Excise Tax”) is imposed on a RIC to the extent that it distributes income in such a way that the income is taxable to shareholders in a calendar year later than the year in which the RIC took a deduction for the distribution.\(^2\) RICs include mutual funds that redeem shares on demand of a shareholder, and exchange-traded funds and “closed-end” companies, whose shares are typically traded on an exchange or over the counter and are, except in the case of certain shareholders of exchange-traded funds, not redeemable upon demand of a shareholder.

**DISCUSSION**

Except as set forth below, the provisions of the Act are effective for taxable years beginning after the date of its enactment.

**A. Repeal of Preferential Dividend Rule for Publicly Traded RICs**

Under current law, “preferential dividends” paid by a RIC are ineligible for the dividends paid deduction.\(^3\) 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.\(^4\) Allocations of expenses, costs and rebates among shareholders may result in “preferential” dividends and because of this concern the IRS has published guidance on the specific circumstances under which such allocations will not result in preferential dividends.\(^5\)

The Act repeals the preferential dividend rule for publicly offered RICs. For this purpose, a RIC is publicly offered if its shares are (1) continuously offered pursuant to a public offering, (2) regularly traded on an established securities market, or (3) held by no fewer than 500 persons at all times during the taxable year.

Notwithstanding the elimination of the preferential dividend rule for publicly offered RICs, applicable securities law will continue to provide limits on the ability of RICs to issue shares that may result in preferences.\(^6\)

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\(^1\) Section 852.

\(^2\) Section 4982.

\(^3\) Section 562(c).

\(^4\) *Id.*


\(^6\) See, *e.g.*, Section 18 of the Investment Company Act of 1940.
B. Capital Loss Carryover

Under current law, if a RIC has a net capital loss for a taxable year, the amount of such 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. In contrast, there is no limitation on the number of taxable years that an individual can carry forward a net capital loss and any net long-term capital losses carried forward by an individual retain their character as long-term capital losses.

The Act provides capital loss carryover treatment to RICs that are similar to the current-law treatment of net capital losses for individuals. Specifically, RICs will now be permitted unlimited carryforwards of their net capital losses and a net long-term capital loss of a RIC carried forward will retain its character instead of being treated as a short-term capital loss.

C. Remedial Provisions for Failure to Satisfy Gross Asset and Income Tests

The Act provides for new savings provisions for failures to satisfy the gross asset and gross income tests applicable to RICs. The new savings provisions are similar to those provided to real estate investment trusts for failures to satisfy the gross income or gross asset tests applicable to real estate investment trusts.

a. Gross Income Tests

A RIC must derive at least 90 percent of its gross income for each taxable year from certain qualified sources, such as dividends, interest and gains from the sale of securities (the "Income Test"). If a RIC fails to satisfy the Income Test in a taxable year, it will fail to qualify as a RIC for such year.

Under the Act, a corporation that fails to meet the Income Test may nevertheless qualify as a RIC if (i) it sets forth in a schedule a description of each item of its gross income and (ii) the failure to meet the gross income test is due to reasonable cause and is not due to willful neglect. If a RIC avails itself of this new remedial provision, a tax will be imposed on such RIC equal to the amount by which the RIC’s gross income from sources which are not qualifying income exceeds one-ninth of its gross income from sources which are qualifying income -- put differently, its “bad” gross income is more than 10 percent of its gross income.

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7 Section 1212(a)(1)(C)(i).
8 Sections 857(c)(6) and (c)(7).
9 For example, if a RIC has $90x of gross income of sources which are qualifying income and $15x of gross income from other sources, a tax of $5x is imposed. The tax is deductible in computing investment company taxable income.
b. Gross Asset Tests

To qualify as a RIC, a corporation must meet certain asset diversification tests on a quarterly basis (the “Asset Tests”).10 There are currently two remedial provisions limiting disqualification for failure to satisfy the Asset Tests. The first remedial provision excuses Asset Test failures in respect of discrepancies attributable to fluctuations in the market value of the RIC’s assets during a quarter,11 and the second allows a RIC to cure Asset Test failures resulting in whole or in part from the acquisition of a security by eliminating the discrepancy within 30 days after the close of the quarter in which it occurs.12 If the remedial provisions do not apply to a corporation’s failure to satisfy the Asset Tests, the corporation will fail to qualify as a RIC.

The Act provides a new rule for de minimis failures of the Asset Tests and a mechanism by which a RIC can cure other failures and pay a penalty tax.

i. De Minimis Failures

The de minimis rule applies if a RIC fails to meet one of the Asset Tests due to the ownership of assets with a total value not more than the lesser of (i) one percent of the total value of the RIC’s assets at the end of the quarter for which the assets are valued, and (ii) $10 million. If the de minimis rule covers an Asset Test failure, the RIC will nevertheless satisfy the Asset Tests if, within six months of the last day of the quarter in which the RIC identifies the failure, the RIC either (i) disposes of assets in order to meet the requirements of the Asset Tests or (ii) otherwise meets the requirements of the Asset Tests.

ii. Non-de minimis Failures

In the case of most Asset Test failures that are not de minimis,13 a RIC will nevertheless meet the Asset Tests if: (i) it sets forth in a schedule a description of each asset that would otherwise cause the RIC to fail to satisfy the Asset Tests; (ii) the failure to meet the Asset Tests is due to reasonable cause and not

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10 In general, at the close of each quarter of the taxable year, at least 50 percent of the value of a RIC’s total assets must be represented by (i) cash and cash items (including receivables), Government securities and securities of other RICs, and (ii) other securities, generally limited in respect of any one issuer to an amount not greater in value than five percent of the value of the total assets of the RIC and to not more than 10 percent of the outstanding voting securities of such issuer. In addition, at the close of each quarter of the taxable year, not more than 25 percent of the value of a RIC’s total assets may be invested in (i) the securities (other than Government securities or the securities of other RICs) of any one issuer, (ii) the securities (other than the securities of other RICs) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses, or (iii) the securities of one or more qualified publicly traded partnerships (as defined in section 851(h)). Section 851(b)(3).

11 Section 851(d).

12 Id.

13 This savings provision does not apply to the extent the failure of the Asset Tests results from more than 25 percent of the value of a RIC’s total assets being invested in the securities (other than Government securities or the securities of other RICs) of any one issuer.
due to willful neglect; and (iii) within six months of the last day of the quarter in which the RIC identifies the failure the RIC (I) disposes of the assets which caused the Asset Test failure or (II) otherwise meets the requirements of the Asset Tests. In the case of failures excused under this provision, a tax will be imposed on the RIC in an amount equal to the greater of (i) $50,000 or (ii) the amount determined by multiplying the highest rate of tax imposed on corporations by the net income generated during the period of Asset Test failure by the assets that caused the RIC to fail the Asset Tests.14

These new remedial provisions are effective for taxable years with respect to which the due date, determined without extensions, of the tax return of the RIC is after the date of enactment of the Act.

D. Pass-through of Exempt-Interest and Foreign Taxes in Fund-of-Fund Structures

Under current law, the character of tax-exempt interest received by a RIC flows through to the RIC’s shareholders in the form of exempt-interest dividends only if at least 50 percent of the value of the total assets of a RIC consist of tax-exempt obligations.15 Similarly, foreign tax credits can be passed along to the RIC’s shareholders only if more than 50 percent of the value of the total assets of the RIC consist of stock in foreign corporations.16 As a result of these constraints, in a “fund-of-funds” structure, in which a RIC holds stock in one or more lower-tier RICs, the upper-tier RIC may not meet the foregoing 50 percent asset requirements and may not be able to pass through these items to its shareholders, even if lower-tier RICs satisfy the asset requirements.

The Act provides that a RIC which is a “qualified fund of funds” may pay exempt-interest dividends and pass through its foreign taxes to its shareholders without regard to whether such RIC satisfies the relevant 50-percent asset requirements. For this purpose, a “qualified fund of funds” is a RIC 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 RICs.

E. Loss Deferral upon Redemption in Fund-of-Funds structure

If the upper-tier RIC in a fund-of-funds structure owns sufficient shares of a lower-tier RIC, they may be members of the same “controlled” group, and as a consequence, a loss sustained by the upper-tier RIC on a redemption of shares of the lower-tier RIC may be deferred.17 The Act provides that the loss deferral rule will not apply to a loss sustained on a redemption of stock of a RIC if the RIC issues only stock which is redeemable upon the demand of the shareholder and the redeeming shareholder is a RIC. The provision applies to distributions after the date of enactment of the Act.

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14 The tax is deductible in computing investment company taxable income.
15 Section 852(b)(5).
16 Section 853.
17 Section 267(f). There would be a controlled group if more than 50% of the lower-tier RIC was owned by the upper-tier RIC.
F. Distributions in Redemption by Publicly Traded RICs

Under current law, the determination of whether redemptions by open-end RICs are treated as distributions in respect of stock or, alternatively, as sale or exchange transactions, is fact-driven and potentially uncertain. Although a redemption of all of the shares of a shareholder is generally treated as a sale or exchange, a partial redemption will generally only be so treated if it is “substantially disproportionate” or “not essentially equivalent to a dividend.”

Under the Act, the redemption of stock of a publicly offered RIC is treated as a sale or exchange if the redemption is upon the demand of the shareholder and the company issues only stock which is redeemable upon the demand of the shareholder. The provision applies to distributions after the date of enactment of the Act.

G. Extension of Class of Shareholders that May Hold Shares in RICs Exempt from Excise Tax

Under current law, the RIC Excise Tax is not imposed on a RIC if at all times during the calendar year each shareholder in the RIC 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 (such RICs, “Exempt RICs”). The Act expands the categories of shareholders that may hold the stock of an Exempt RIC to include (i) tax-exempt entities whose ownership of beneficial interests in the RIC would not preclude the application of Section 817(h)(4), and (ii) other Exempt RICs. The provision applies to calendar years beginning after the date of enactment of the Act.

H. Omission of Provision Relating to Income From Commodities in Final Version of the Act

Under current law, gain and income from direct investments by a RIC in commodities is generally not qualifying income for purposes of the Income Test. Additionally, the IRS has ruled that income from a derivative contract providing a total return exposure on a commodity index is also not qualifying income. As a consequence, RICs have sought exposure to commodities by investing in notes linked to

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18 Section 302(b)(3).
19 Section 302(b)(2).
20 Section 302(b)(1).
21 A RIC is a publicly offered RIC if its shares are (1) continuously offered pursuant to a public offering, (2) regularly traded on an established securities market, or (3) held by no fewer than 500 persons at all times during the taxable year.
22 Section 4982(f).
23 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 a pension plan described in Section 501(c)(18). See Rev. Rul. 94-62, 1994-2 C.B. 164, as supplemented by Rev. Rul. 2007-58, I.R.B. 2007-37.
commodities, which are treated as securities and thus produce qualifying income\textsuperscript{25} or, within the limits imposed by the Asset Tests,\textsuperscript{26} by investing in commodities through foreign subsidiaries.\textsuperscript{27}

An earlier version of the Act that was passed by the House of Representatives in September would have modified the Income Test to include a RIC's gains from the sale or other disposition of commodities, as well as other income of a RIC (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in commodities, in qualifying income.\textsuperscript{28} Because of concerns about the effect on the commodities market, however, this provision was not included in the Act as passed by Congress and signed into law.\textsuperscript{29} In the absence of this provision, RICs will presumably continue to invest in commodities indirectly through foreign subsidiaries or through commodity-linked notes.

**MISCELLANEOUS**

The Act also makes the following changes in law:

a. **Calculation of earnings and profits**

Under the Act, deductions of a RIC that are disallowed because related to tax-exempt interest income will reduce earnings and profits. As a consequence, distributions in excess of earnings and profits will be treated by shareholders as returns of basis or as gain from a sale of the shares and not as taxable dividends.\textsuperscript{30}

Consistent with current law,\textsuperscript{31} the Act provides that a net capital loss for a taxable year is not taken into account in determining earnings and profits. Any capital loss treated as arising on the first day of the next taxable year of the RIC is taken into account in determining earnings and profits for the next taxable year, subject to the application of the net capital loss rule to that year.

\textsuperscript{25}See, e.g., PLRs 201031007, 200822012, 200705026, 200701020, 200647017, 200637018 and 200628001.

\textsuperscript{26}Under Section 851(b)(3)(B), not more than 25% in value of a RIC’s assets may consist of shares or securities of any one issuer or of two or more controlled issuers engaged in the same or similar businesses.

\textsuperscript{27}See, e.g., PLRs 200936002, 200932007.

\textsuperscript{28}That version of the Act would also have repealed the regulatory authority to exclude certain foreign currency gains from qualifying income.

\textsuperscript{29}Had this version of the Act been enacted by Congress, the responsibility to regulate to what extent a RIC is able to invest in commodities would have been left to the financial regulatory agencies.

\textsuperscript{30}Under prior law, the deductions did not reduce earnings and profits, with the consequence that a distribution of the expenses (\textit{i.e.}, a distribution by a RIC of more than its net tax-exempt interest) would be treated as a taxable dividend to the shareholders to the extent of the disallowed expense.

\textsuperscript{31}Section 851(c)(1).
b. Repeal of Penalty on Deficiency Dividends

Under current law, a RIC that pays a “deficiency” dividend – generally, a dividend paid because of adjustments that result in increases in investment company taxable income or net capital gain for a prior year – is subject to both an interest charge and an additional penalty.32 The Act repeals the imposition of the additional penalty in respect of a deficiency dividend.

c. Spillover Dividends

A RIC may elect to treat certain dividends (so-called “spillover” dividends) paid after the close of its taxable year as paid during the year for purposes of determining whether it meets the distribution requirement and for purposes of the dividends paid deduction.33 The Act extends the time for declaring a spillover dividend to the later of the 15th day of the 9th month following the close of the RIC’s taxable year or the extended due date for filing its return. The Act also provides that the spillover dividend must be made not later than the date of the first dividend payment of the same type of dividend (for example, an ordinary income dividend or a capital gain dividend) made after the declaration.

d. Losses Due to Load Charges

Under current law, if a shareholder disposes of shares of a RIC within 90 days following their acquisition, and the shareholder subsequently re-acquires shares of that RIC or another RIC (i) pursuant to a reinvestment right received upon the purchase of the original shares and (ii) at a reduced load charge, the shareholder cannot recognize on a current basis the loss on the original shares attributable to the amount of the load charge.34 The Act limits the applicability of this provision to situations in which the taxpayer subsequently acquires stock before January 31 of the calendar year following the calendar year the original stock is disposed of.

e. Required Distribution for RIC Excise Tax purposes

The Act increases the required distribution percentage of the capital gain net income of a RIC for purposes of avoiding the imposition of the RIC Excise Tax from 98 percent to 98.2 percent. The provision applies to calendar years beginning after the date of enactment of the Act.

32 If there is a determination that a RIC has a tax deficiency with respect to a prior taxable year, the RIC can distribute a “deficiency dividend.” Section 860. For example, if an IRS audit of a RIC results in a deficiency in tax owed by the RIC for a prior taxable year, the RIC may reduce or eliminate such tax by paying a deficiency dividend to its current shareholders, which can be related back to the audited taxable year.

33 Section 855.

34 Section 852(f). The provision only applies to the extent of the amount of the reduction in load charges by reason of the reinvestment right. To the extent the original load charge is not taken into account on the disposition of the original shares, such charge shall be treated as incurred in connection with the acquisition of the subsequent shares.
f. Modification to Designation and Allocation Requirements

Under the Act, RICs are no longer required to designate the character of dividends within 60 days of the end of a year. Dividends will henceforth simply be reported by the RIC “in written statements furnished to shareholders” as capital gain dividends, exempt-interest dividends, distributions in respect of foreign taxes, dividends eligible for the dividends received deduction, or qualified dividend income. It is expected that the reporting will be on a Form 1099.

The same notification procedure will apply to short-term capital gain and interest-related dividends paid to foreign shareholders of a RIC. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, signed on December 17, 2010, extended the withholding tax exemptions for these dividends to dividends with respect to taxable years of a RIC beginning before 2012.35

The Act also provides that return of capital distributions of a fiscal year RIC will be allocated by treating distributions made on or before December 31 of the taxable year as coming first out of earnings and profits. The Act also provides similar rules regarding the “excess reported” amounts of long-term capital gain dividends, exempt-interest dividends, interest-related dividends and short-term capital dividends in the case of a fiscal year RIC. These are intended to reduce the need for RICs to amend statements to shareholders and shareholders to amend returns on account of the over designation by a RIC of the amount of a dividend that is eligible to be designated as one of the types of dividends described in the previous sentence.

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