REPORT #678

TAX SECTION

New York State Bar Association

CURRENT ISSUES IN THE
FEDERAL INCOME TAX TREATMENT OF
REGULATED INVESTMENT COMPANIES

January 4, 1991

Table of Contents

TAX SECTION

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The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Gideon:

I enclose our Report on Current Federal Income Tax Issues in the Taxation of Regulated Investment Companies. The principal authors of the Report are Thomas A. Humphreys and David Z. Nirenberg from the Committee on Financial Institutions.

Because we believe the RIC tax rules work fairly well, the Report does not recommend significant changes in current law. There are, however, technical problems with the current statute that we believe deserve attention in order to make the RIC rules simpler and more efficient. In addition, we believe that there are several points the Internal Revenue Service could clarify through the ruling process that would also improve the simplicity and efficiency of the statutory scheme.

These steps should be taken to allow RIC's to function as efficiently and inexpensively as possible as mechanisms for bringing capital to the securities markets.

The Report is being submitted at this time in part because the Securities and Exchange Commission is currently conducting an extensive study of the regulation of investment companies. We hope that the SEC, the Service and the Treasury will coordinate any revision of the regulatory scheme for investment companies.

We trust that this Report will be useful to you.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

Identical letter to:

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Tax Report #678

CURRENT ISSUES
IN THE
FEDERAL INCOME TAX TREATMENT
OF
REGULATED INVESTMENT COMPANIES

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON FINANCIAL INSTITUTIONS

January 4, 1991

I. Introduction[1]

In 1983, the Committee on Financial Institutions and Insurance Companies of the New York State Bar Association Section of Taxation wrote a report (the "1983 Report") on the provisions of the Internal Revenue Code relating to regulated investment companies ("RICs")[2] The 1983 Report recommended several changes in the federal income tax treatment of RICs. Some of these recommendations were enacted as part of the Tax Reform Acts of 1984 and 1986.[3] Many of the 1983 Report's recommendations, however, have not yet been implemented.[4]

This report makes further recommendations for simplifying the technical operation of the RIC provisions. We think this is important since RICs are a major mechanism for bringing capital into the securities markets and therefore should function as efficiently and inexpensively as possible. This is consistent with the administration's view that it is important to improve the availability of capital for American business. Although we are not experts in the area, we do not believe that

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1 This report was prepared by members of the New York State Bar Association Section of Taxation Committee on Financial Institutions. The principal authors are Thomas A. Humphreys and David Z. Nirenberg. Helpful comments were received from John A. Corry, Christina A. Cotton, Arthur A. Feder, James A. Levitan, Ralph O. Winger and Paul L. Wright.

2 Sections 851-855. Unless otherwise indicated or the context otherwise requires, references to sections herein are to the Internal Revenue Code of 1986 (the "Code") or the Treasury regulations promulgated thereunder. The 1983 Report is published in Tax Notes, November 28, 1983, p. 747.

3 Among these were recommendations that (i) series funds be treated as separate corporations (now codified in section 851(h)), (ii) the limitation on personal holding companies electing RIC status be eliminated, and (iii) the types of passive income that qualify for the 90 percent income test of section 851(b)(2) be expanded.

4 Among these were recommendations that (i) the short-short test of section 851(b)(3) be repealed, (ii) dividends paid by a RIC that invests primarily in debt obligations qualify as interest for purposes of determining the tax liability of recipients that are non-resident aliens and foreign corporations, and (iii) the definition "cash items (including receivables)" as used in the diversification test of section 851(b)(4)(A)(i) be expanded to treat as a cash item any obligation whose original maturity is no more than one year.

the changes we recommend would have any revenue impact whatsoever.

Our major recommendations are as follows:

(i) The Code should be amended to permit a RIC, subject to an overall anti-avoidance rule, to deduct all dividends (as defined under section 316) paid to shareholders in computing its taxable income;

(ii) A published ruling should be issued providing that a RIC shareholder in a dividend reinvestment plan who receives a distribution of the RIC's shares should be treated as receiving a distribution equal to the amount of cash distributed to shareholders that do not participate in the plan;

(iii) The Code should be amended to clarify the application of the section 851(b)(4) diversification tests to options, futures and forward contracts;

(iv) The Code should be amended to permit the pass-through of portfolio interest under sections 871(h) and 881(c) to foreign RIC shareholders;

(v) The Code should be amended to permit the pass-through of interest on U.S. Treasury obligations to RIC shareholders;

(vi) The current restrictions on passing through tax-exempt income and foreign source income (and foreign tax credits) should be eliminated;

(vii) A new Code provision should be added which permits a RIC to pass through as non-cash income certain items of non-cash income at the RIC level such as original issue discount income;

(viii) A published ruling should be issued which clarifies that income from swaps, caps, collars and floors used to hedge a RIC's portfolio investments is qualifying income;

(ix) The Code should be amended to relax the section 851(b)(4) diversification test in the RIC's first taxable year; and

(x) The Code should be amended to allow a RIC to meet the 50 percent diversification requirement of section 851(b)(4)(A)(ii) with securities of one issuer not greater in value than 10 percent (rather than five percent) of the RIC's assets.

II. Background

Although it made technical recommendations, the 1983 Report recommended against a wholesale revision of the RIC provisions. The introduction to the 1983 Report stated, "The Committee believes that this basic structure (i.e., the Code provisions relating to RICs) is sound and that no general overhaul is required." The Committee[5] still believes that the basic statutory framework for taxing RICs is sound and that no wholesale revision is necessary. The Securities and Exchange Commission (the "SEC") is, however, reexamining the regulation of investment companies in light of the significant changes in the securities markets in recent years[6] The Committee believes that these changes (as well as amendments to the Code since 1983) make appropriate, as well, a reexamination of the rules relating to the taxation of RICs, to determine whether technical changes to those rules should be made. Further, the Committee believes that in making any determination regarding the general reform of the securities and tax rules relating to investment companies, it is

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5 The Committee on Financial Institutions is a successor to the Committee on Financial Institutions and Insurance Companies.

6 See Securities and Exchange Commission, "Request for Comments on Reform of the Regulation of Investment Companies," Release Nos. 33-6868, 34-28124, IC-17534, IA-1234, International Release No. 128, File No. 57-11-90, reprinted at 55 Fed. Reg. 25322 (June 21, 1990) (the "SEC Request").

important that the SEC, the Department of the Treasury ("Treasury") and the Internal Revenue Service ("Service") understand how well the current tax rules relating to RICs work, and how, within the current framework, they can be improved.

In this report we will suggest a framework for analyzing any regime for taxing pooled investment vehicles. Using that analysis, we will then identify certain of the weaknesses and discontinuities of the current tax rules that apply to RICs, and suggest ways the current rules could be improved through legislation or administrative action. To establish a context, however, we will first summarize certain of the most significant changes in the financial markets and amendments to the Code that affect RICs and their investors.

Since 1983 the world's financial markets have changed dramatically:

(1) The world's financial markets have become increasingly internationalized. United States investors have increasingly purchased securities of non-U.S. issuers (including both dollar and non-dollar denominated obligations) and foreign investors are increasingly purchasing securities of U.S. issuers. RICs in particular have become internationalized; many RICs invest virtually exclusively in securities of issuers of one country or one geographic region. Further, many RICs that invest primarily in U.S. securities are

increasingly diversifying their portfolios with significant investments in non-U.S. securities[7] Because of the lack of knowledge of foreign laws and market practices, for many investors, an investment in a pooled investment vehicle is the only practical way to invest in many non-U.S. securities.

(2) Many new financial products have either been developed or become widely held and traded since 1983. RICs are increasingly holding these products, including notional principal contracts, such as swaps, caps, floors and collars and mortgage- and asset- backed securities including securities issued by real estate mortgage investment conduits (“REMIC”s), as well as conventional derivative products such as options, forward contracts and futures. Because these new financial products are often complex (and ever changing) and the minimum practical investment in them is high, as with foreign securities, for many investors the only practical way to invest in these new products is through a pooled investment vehicle.

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[7] According to the SEC Request (footnote 10), as of December 31, 1989, there were 193 U.S. investment companies, with total assets of about $27 billion, investing primarily in foreign securities. Further, an additional 50 investment companies with total assets of about $15.1 billion, had at least 25 percent of their portfolios invested in securities traded outside the United States.

(3) RICs have increasingly issued preferred stock and debt. The use of multiple classes of securities is designed generally to provide leverage for the investors in the RIC's common stock or to allow different classes of investors to be allocated different classes of the RIC's income and thus satisfy differing investment objectives.[8]

The Code has also been amended since 1983 in many ways that affect RICs, both directly and indirectly:

(1) RICs have directly and positively been affected by the enactment of section 852(h) that treats series funds as separate corporations and by the expansion of the types of passive income that qualify for the 90 percent of income test of section 851(b)(2).

(2) RICs have also been directly and significantly affected by the enactment of section 4982 which imposes an excise tax on a RIC’s undistributed earnings.

(3) One amendment to the Code that, although not directed at RICs, has had a significant effect, is the repeal of the 30 percent U.S. withholding tax on portfolio interest. Because the RIC rules were not amended to permit a RIC to designate dividends

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[8] Last year, the Service issued Revenue Ruling 89-81, 1989-1 C.B. 226, which held that in the case of a RIC that has more than one class of stock, if the RIC designates the dividends paid on one class of stock as consisting of more than that class's proportionate share of a particular type of income, the designation will be ineffective for federal income tax purposes.

paid out of interest income as interest, pooled investment vehicles designed to permit foreign investors to invest in debt obligations of U.S. issuers are typically established offshore and not as RICs.[9]

In analyzing how these market and tax law changes affect RICs and whether the rules relating to the taxation of RICs need to be modified, it is necessary to define the various goals. The Committee suggests that the following criteria be used as standards for judging the current RIC tax rules, and to measure the advisability of any potential changes. First, the method of taxing RICs and their shareholders should be simple. Because an investment company can lose its conduit treatment for federal income tax purposes if it fails to comply with the RIC tax rules, it is important that a RIC be able to understand and comply with those rules. This is particularly important for RICs that invest in new financial instruments the taxation of which is itself uncertain. Moreover, RIC shares are widely held by millions of U.S. and foreign investors, many of whom are unsophisticated.

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9 Forcing investment vehicles offshore makes them less efficient because, among other reasons, (i) they must comply with sections 864(b)(2)(A) and 1.864-(2)(c) to avoid being considered to be “engaged in a trade or business within the United States” and (ii) equity interests in these vehicles are less attractive to U.S. investors because of the complexity (although not necessarily any additional tax cost) arising from the passive foreign investment company/qualified electing fund rules of sections 1291-1297.

They must be able to easily understand the taxation of their investments, first, in order to evaluate the merits of investing and, second, to properly prepare their own income tax returns.

Second, the method of taxation of RICs and their shareholders should lead, as closely as is practicable, to the results that would be obtained if a shareholder made the investment directly. This goal is consistent with the notion that a RIC is merely a conduit designed to allow investors to band together to take advantage of economies of scale and to have their portfolios managed by professional managers. Except as is necessary to provide simplicity, the conduit should not distort the taxation of the shareholder's investment. The tax law should neither penalize an investor for investing through a RIC nor permit an investor to take advantage of the RIC rules to achieve tax arbitrage.[10]

Third, the federal income tax rules affecting RICs should limit the benefits of their provisions to entities that are investment vehicles (and not entities that actively engage in business) but, nonetheless, be flexible enough to permit adaptation to a changing investment environment, with respect both to the investments available to a RIC and the securities it issues to investors. It should not be necessary to amend the

[10] For example, section 852(b)(4)(B) prevents a taxpayer from artificially creating a loss by buying stock in a RIC that pays exempt-interest dividends immediately prior to the stock trading ex-dividend and then selling it immediately thereafter.

Code (or that dramatic administrative action be taken) each time changes in the financial markets require investment companies to respond.

In many cases, the goals of the tax law can be achieved by giving deference to the securities laws' regulation of RICs. Obviously, for any given concern, a regulatory scheme that requires compliance with only one set of regulations is simpler than a scheme which requires compliance with two different sets of regulations. Also obvious, however, is that, if two regulatory bodies have significantly different goals, one's ceding to the other of the regulation of activities relating to any given concern may frustrate the goals of the ceding regulatory body. For example, we believe that section 851(c)(5), which provides, for the RIC diversification test, that all terms not otherwise defined have the meanings ascribed to them in the Investment Company Act of 1940 (the "1940 Act") is helpful because, by providing certainty as to the classification of certain investments, it eases the determination of whether a RIC may purchase those investments[11] Conversely, we would not suggest

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[11] See, e.g., Rev. Rul. 77-342, 1977-2 C.B. 238 (participation certificates issued by the General Services Administration are "government securities"); Rev. Rul. 77-199, 1977-1 C.B. 195 (certificates of deposit are "cash items"); G.C.M. 39626 (April 30, 1987) (mortgage pass-through certificates issued by government agencies are "government securities"). Reliance on the 1940 Act alleviates the need to determine for purposes of the Code diversification test if corporations, such as the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association that are quasi-government entities are part of the "government" and whether short-term debt instruments, pass-through certificates and other investment assets which might not necessarily be securities for purposes of subchapter C are securities under subchapter M.

that the diversification test of section 851(b)(4) be abandoned merely because section 5(b)(1) of the 1940 Act contains a diversification test. The two diversification tests have different goals. The 1940 Act requires diversification to protect investors; section 851(b)(4), to limit the benefits of the RIC rules to passive investment companies rather than active businesses (or holding companies for active businesses). If, for example, application of the favorable tax rules for RICs required that an investment company be diversified within the meaning of section 5(b)(1) of the 1940 Act, the securities law goal of allowing non-diversified investment companies to be registered (subject to certain investor protection rules) would be frustrated because of the significant inefficiencies arising out of losing pass-through status for tax purposes. Similarly, if the Code's diversification rules were eliminated, the goal of the tax law that RICs be passive investment vehicles might be frustrated because, for example, at least in theory, the 1940 Act permits companies that are essentially non-diversified holding companies to register as investment companies, if they hold themselves out to the public as investment companies. Accordingly, the Committee believes that in evaluating any tax rule, the rule must be tested generally against the goals of the tax regime, but also against the simplification that would arise from relying solely, or in part, on any similar securities regulations. Further, the Treasury and the Service should entirely cede to the Securities and Exchange Commission (“SEC”) the regulation of concerns that do not relate to the goals of the tax law. Accordingly, for example, the Committee has excluded from the list of goals of the tax law, goals relating to investor protection and the appropriateness of investments. We believe rules relating to these worthy goals should be left entirely in the hands of the SEC.

With the above framework in mind, Part III of this report describes the current system of RIC taxation. Part IV analyzes the current system in light of the goals described above, and provides the Committee's recommendations regarding technical changes to the RIC taxation rules.

III. The Current System of RIC Taxation

A. A Brief History of the RIC Provisions

The current RIC tax rules are in parts I and III of subchapter M of chapter 1 of the Code. RIC provisions also appear in the excise tax rules (section 4982), alternative minimum tax rules (section 56(f)(4), section 56(g)(6)), the net capital loss carryover rules (section 1212(a)(1)(C)(i), section 1212(a)(3)(B)), the floor on itemized deduction rules (section 67(c)), consolidated return rules (section 1504(b)(6)) and dividends-paid deduction rules (section 562).

Subchapter M has its roots in the Revenue Act of 1936 ("1936 Act"). The 1936 Act provided that a "mutual investment company" was exempt from taxation under the federal income tax laws. The provision was limited to corporations "organized for the purpose and engaged exclusively in holding, investing or reinvesting in stocks or securities[12] The definition of a mutual investment company included provisions similar to the 90 percent test of current section 851(b)(2), the short-short test of current section 851(b)(3), the diversification requirements of current section 851(b)(4), a 90 percent distribution requirement similar to that in current section 852(a)(1)(A), and a limitation on holdings by one individual investor of 10 percent or less of the mutual investment company's stock[13] The statute also required that shareholders be entitled, on reasonable notice, to redeem their stock for their interests in the corporation's property or cash equivalent thereto, less a discount of not more than three percent.[14]

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[12] Revenue Act of 1936, §48(e)(1)(A), 49 Stat. 1648.

[13] Revenue Act of 1936, §48(e), 49 Stat. 1648.

[14] Revenue Act of 1936, §48(e)(1)(E),49 Stat. 1648. One Senator commented with respect to the statute: "I think it is full of many possible loopholes; and I hope it will be watched very carefully to see that no person not entitled to the exemption takes advantage of it." 80 Cong. Rec. 9070 (1936) (remarks of Senator Couzens).

The Revenue Act of 1942 (“1942 Act”) substantially rewrote the 1936 Act provisions in light of the adoption of the 1940 Act. The name “regulated investment company” replaced the term “mutual investment company”[15] Additionally, the definition was revised to exclude personal holding companies and to require that the corporation be registered at all times during the taxable year under the 1940 Act as either a management company or a unit investment trust or be a common trust fund not otherwise covered under the existing common trust fund provisions of federal income tax law.[16] The requirement that shareholders be entitled to redeem their shares was dropped, thus allowing closed-end investment companies to qualify for the special tax treatment.[17] The diversification tests were refined and a catch-all provision was included to define otherwise undefined terms as they were defined in the 1940 Act. The 1942 Act also permitted a RIC to either (i) retain its capital gains and still qualify as a RIC, subject to a 25 percent tax,[18] or (ii) pay a capital gain dividend much like the current capital gain dividend permitted

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[15] Revenue Act of 1942, §170(a), ch. 619, 56 Stat. 798.

[16] Id.

[17] See S. Rep. No. 1631, 77th Cong., 2d Sess. (1942).

[18] Revenue Act of 1942, §170(a), ch. 619, 56 Stat. 798.

under section 852(b)(3). Additionally, the 1942 Act required that the RIC make an affirmative election to be treated as such.

In 1950, the Code was amended to permit a RIC to pay a sweep-out dividend within 75 days after the close of the taxable year under the predecessor of section 855.[19] And in 1951, the RIC rules were relaxed to permit certain venture capital companies to operate in RIC form.[20]

The Internal Revenue Code of 1954 revised and rearranged the RIC provisions into a format similar to their current format[21] Section 853 was added to allow the pass-through of foreign source income and foreign tax credits. Section 854 was added to allow the pass-through of dividends-received deduction income.

No significant changes were made until 1976 when Congress added section 852(b) to the Code which extended pass-through treatment to exempt interest on state and local government bonds[22] In 1978, a deficiency dividend procedure was added in section 860 applicable to both RICs and real estate

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[19] Revenue Act of 1950, §222, ch. 994, 64 Stat 906.

[20] Revenue Act of 1951, §337(a), ch. 521, 65 Stat. 452.

[21] Internal Revenue Code of 1954, sections 851-855.

[22] Tax Reform Act of 1976, Pub. L. No. 94-455, §2137, 90 Stat. 1520

investment trusts (“REIT”s).[23] In 1984, the provisions of section 854 were revised.[24]

In the Tax Reform Act of 1986 (“1986 Act”) significant changes were made including (i) expanding the types of qualifying income to include gains from options, futures, forwards and any other income related to the RICs principal business of investing in stocks and securities, (ii) treating series funds as separate corporations for federal income tax purposes, (iii) providing netting treatment for the gains and losses in certain designated hedging transactions for purposes of the section 851(b)(3) short-short test, (iv) adding the section 4982 excise tax on undistributed income and (v) permitting business development companies (“BDCs”) to qualify as RICs. In 1988 and 1989, certain technical corrections were made to the statute.[25]

B. The Current System

The current system of RIC taxation depends on two key Code sections, sections 851 and 852. Section 851 prescribes the basic RIC qualification rules. Section 852 includes the 90 percent distribution requirement as well as the mechanical rules

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23 Revenue Act of 1978, Pub. L. No. 95-600, §156, 92 Stat. 2801.

24 Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494.

25 See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 and Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 251.

for computing a RIC’s taxable income, the tax (if any) at the RIC level, and the rules for passing through capital gain and exempt-interest dividends[26]

Section 851(a) defines the term “regulated investment company”. Section 851(b), however, contains the most important qualification rules, phrased as limitations on the ability to qualify as a RIC. These limitations, in brief, are:

> (1) The section 851(b)(2) requirement that at least 90 percent of the RIC's gross income each year be derived from dividends, interest, payments with respect to securities loans (section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in the 1940 Act) or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities or currencies.
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> (2) The section 851(b)(3) requirement that less than 30 percent of the RIC’s gross income each year be derived from the sale or disposition of any of the following items held for less than three months: (i) stock or securities (as defined in the 1940 Act), (ii) options, futures, or forward contracts (other than

[26] As noted in the previous section, section 853 contains the rules for passing through foreign source income and foreign tax credits. Section 854 contains the rules for passing through income eligible for the section 243 dividends-received deduction. Section 855 contains the rules for “sweep-out” dividends. Section 860 provides rules for deficiency dividends of both RICs and REITs.

options, futures, or forward contracts on foreign currencies), or (iii) foreign currencies (or options, futures, or forward contracts on foreign currencies) that are not directly related to the RIC’s principal business of investing in stocks or securities (or options and futures with respect to stocks or securities).

(3) The section 851(b)(4) requirement that at the close of each quarter of the taxable year, (i) at least 50 percent of the value of the RIC’s assets is represented by (A) cash and cash items (including receivables), Government securities and securities of other RICs, and (B) other securities limited in respect of any one issuer to an amount not greater in value than five percent of the RIC's total assets, and to not more than 10 percent of the outstanding voting securities of such issuer, and (ii) not more than 25 percent of the RIC’s total assets are invested in the securities (other than Government securities or securities of other RICs) of any one issuer, or two or more issuers controlled by the RIC and which are engaged in the same or similar trades or businesses or related trades or businesses.

Section 852(a)(1) requires that each year the RIC must distribute (i) 90 percent of its investment company taxable income (“ICTI”), and (ii) 90 percent of its net tax-exempt income. Section 852(a)(2) requires either that the investment company has qualified as a RIC for all taxable years ending on or after November 8, 1983, or that the investment company has no earnings and profits accumulated in a non-RIC year as of the close of the taxable year.

Section 852(a)(2) contains the rules for the taxation of the RIC and its shareholders. In general, a RIC is taxed at section 11 rates on its ICTI. ICTI is the RIC's taxable income (i) reduced by net capital gain, (ii) computed without regard to the section 172 net operating loss deduction, (iii) computed without regard to the corporate deductions allowed in subchapter B of the Code (except section 248) including the section 243 dividends-received deduction, and (iv) reduced by the dividends-paid deduction (computed under section 561) but without regard to capital gain dividends and exempt-interest dividends.

Section 852(a)(3) contains the rules for capital gain dividends including the rules, under section 852(a)(3)(D) for undistributed capital gains. Section 852(a)(5) contains the rules for exempt-interest dividends. Sections 852(a)(4) and 852(a)(6)-(9) contain miscellaneous rules applicable to shareholders and to the RIC itself.

Section 852(c) provides that a RIC's earnings and profits for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income for such taxable year.

IV. Suggestions for Changes in the Current System of Taxation

A. Introduction

Because the current system works well we do not believe it should be replaced with a completely new system. Although some new system might be theoretically more “pure” from a tax standpoint, it will have problems of its own. Additionally, the costs of converting to any completely new system, and the confusion that is bound to be engendered among investment advisors and shareholders would make any new system unworkable for years. Moreover, any completely new system would mean that the current well-developed body of law and regulations applicable to RICs would be made obsolete. Regulations under a new statute could take years to issue[27] and there would be a prolonged period of regulatory uncertainty that would be unacceptable for RIC shareholders and investment advisors. Instead, as in 1983 we believe the best approach is to improve the current system. We have several suggestions for doing so, keeping in mind the goals of simplification, re-creating the effects of direct investment, and flexibility.

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[27] For example, although the REMIC rules were enacted as part of the 1986 Act, no substantive regulations have yet been issued under the REMIC provisions.

B. Simplification

1. The Current System is Relatively Simple from a Shareholder Standpoint; It Could Be Made Simpler from the RIC's Standpoint

As we noted above, simplicity is one of the important yardsticks for measuring any system of RIC taxation. We think that from a shareholder standpoint the current system meets this goal. While the current system is more complicated from a RIC standpoint, most RICs and practitioners are able to devote the resources necessary to understand and comply with the current rules. Nevertheless, some improvement here is possible.

a. Simplicity at the Shareholder Level

The system is simple from a shareholder standpoint because it uses the subchapter C model. Shareholders receive only dividend income from a RIC. This dividend income can be designated, subject to certain rules, by the RIC as one of four types of income (i) ordinary dividend income not eligible for the dividends-received deduction, (ii) ordinary dividend income eligible for the dividends-received deduction, (iii) long-term capital gains, and (iv) tax-exempt income. The information necessary for a shareholder to compute its taxes, therefore, is easily put on Form 1099 and usually easily understood by the shareholder.

The lack of inside basis adjustment inherent in a subchapter C model also greatly simplifies the treatment of both the RIC and the investor. Thus, as noted above, at the RIC level there is no ability (or requirement) that the RIC adjust the inside basis of assets with respect to purchases of shares by an investor. At the shareholder level the investor has a basis in the RIC shares rather than a share of the basis in the RICs assets.

One drawback of this simplicity is that an investor may buy built-in gain and be taxed on it even though another investor has already been taxed on such gain. Alternatively, an investor may buy high basis, depreciated assets and in effect use the built- in losses to offset future appreciation in the RICs assets, even though his transferor was entitled to deduct the loss. Another drawback is that losses at the RIC level do not flow through to the RIC shareholder. In general, however, we believe that the advantages of simplicity far outweigh the possible benefits of a "perfect" system of conduit taxation[28]

b. Simplicity at the RIC Level

At the RIC level, simplicity should be assessed in three ways. First, are the computations of a RIC's gross income, taxable income, ICTI and dividends-paid to shareholders sufficiently simple? Second, is it easy for a RIC to comply with the rules designed to determine RIC qualification? These include the structural qualification tests under section 851(a), the limitations on qualification in section 851(b) and the 90 percent

[28] For example, many very large partnerships purposely do not make section 754 elections because adjusting the basis of assets on every sale of a partnership interest would be simply too complex and expensive.

distribution requirement in section 852(a). Third, are the shareholder reporting requirements and RIC recordkeeping rules sufficiently simple?

(i) Income. Etc. Computations

A RIC faces the normal problems applicable to all corporations (as well as other taxpayers) in computing its gross income and taxable income. For example, a RIC must apply the section 1092 straddle rules to its losses to determine whether such losses can be currently recognized. Although there are obviously many comments that could be made about simplicity in the tax world at large they are beyond the scope of this report. On the other hand, the rules for the computation of ICTI are relatively straightforward. The chief exception, however, is the use of section 561 to determine whether a RIC receives a deduction for dividends paid to its shareholders. This cross-reference currently leads to some of the most frequent problems in the RIC area. Simplification of this rule would do a great deal toward simplifying the RIC tax rules.

By way of background a RIC is only entitled to deduct distributions to its shareholders which qualify for the dividends-paid deduction under section 561. Under section 562(c), a distribution is not deductible under section 561 unless it is “pro rata” with no preference to any share of stock as compared with other shares of the same class, except to the extent that the former is entitled “to such preference.” The link to section

562(c) is problematic because there is little authority under this Code section as it relates to a widely-held corporation or to complex modern financial instruments.

For example, several fund complexes have adopted so-called dual distribution plans. The purpose of such a plan is to allow a RIC to give investors the option of paying a front-end sales charge or, instead, to pay a back-end sales charge coupled with a Rule 12b-1 distribution fee[29] This arrangement necessarily involves different amounts of distributions to different shareholders. Thus, the shareholder electing the front-end load does not have its distributions reduced currently by a section 12b-1 fee. The shareholder electing the back-end load, however, has reduced distributions as a result of deduction of the section 12b-1 fee.

The Service initially ruled that such dual distribution plans did not result in preferential dividends because the front-end load shares and back-end load shares were two different classes of stock and section 562(c) permits different

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[29] Section 12b-1 of the 1940 Act provides....”It shall be unlawful for any registered open-end company (other than a company complying with the provisions of section 10(d)) to act as a distributor of securities of which it is the issuer, except through an underwriter, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” Rule 12b-1 permits payment of distribution expenses by an investment company under limited circumstances. Such fees are typically computed as a percentage of an investment company's net assets and paid periodically to the distributor by the investment company.

distributions if a class is entitled to such distributions[30] A year later, the Service ceased ruling for an 18-month period. Earlier this year the Service ruled that the front-end and back-end shares were one class of stock under section 562(c).[31] The Service went on to state that distributions on this single class of stock were not preferential because the back-end load shareholder was deemed to receive (but only for section 562(c) purposes) the section 12b-1 fee. This rather tortured reasoning was necessary because of the linkage to the section 561 dividends-paid deduction.

As a second example, a popular type of preferred stock permits a shareholder to designate the length of its next dividend period and to receive a corresponding rate from the issuer that is determined under an auction or remarketing mechanism. Industrial corporations use this sort of stock regularly. The Service, however, has balked at ruling that the stock does not produce a preferential dividend, apparently on the theory that similarly situated shareholders are receiving different amounts even though the different amounts are set

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[30] Private Letter Ruling 8810007 (March 23, 1987), Private Letter Ruling 8817029 (January 28, 1988), Private Letter Ruling 8850055 (September 21, 1988), Private Letter Ruling 8819008 (May 29, 1987) and Private Letter Ruling 8806006 (August 27, 1987).

[31] Private Letter Ruling 9036023 (June 11, 1990), Private Letter Ruling 9047070 (August 30, 1990), Private Letter Ruling 9048023 (August 30, 1990) and Private Letter Ruling 9049016 (September 7, 1990).

through a market mechanism that is not subject to manipulation by either the issuer or the holder. Here, the lack of authority under section 561 acts to deny a RIC the same corporate finance tools available to a normal C corporation[32]

The difficulties in applying the section 562(c) preferential dividend rules are compounded because the reasons for the rule as well as the reason for applying it to RICs are uncertain. Section 562(c) had its origins in the 1936 Act. A corporation received a credit against the surtax on undistributed profits for dividends paid except that no credit was allowed "with respect to any distribution unless the distribution is pro rata, equal in amount, and with no preference to any share of stock with other shares of the same class."[33] The legislative history of the 1938 Act sheds a little more light on the reasons for the provision:

> No dividends-paid credit should be allowed in the case of a distribution not in conformity with the rights of shareholders generally inherent in their stockholdings, whether the preferential distribution reflects an act of injustice to shareholders or a device acquiesced in by shareholders, rigged with a view to tax avoidance

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32 While a RIC could issue such stock without a private letter ruling the consequences of being wrong, i.e., a corporate level tax on its income, make this an unattractive option. To date, the Service has only issued rulings where the preferred stock is issued in distinct series and the holder of the preferred stock has no ability to change the dividend period. See Private Letter Ruling 8903073 (October 26, 1988), Private Letter Ruling 9023020 (March 7, 1990), Private Letter Ruling 9024039 (March 16, 1990), Private Letter Ruling 9038020 (June 22, 1990), Private Letter Ruling 9028043 (July 13, 1990), and Private Letter Ruling 9041065 (July 18, 1990).

33 Revenue Act of 1936, §27(g), 49 Stat. 1648.

> ... [N]o distribution which treats shareholders with substantial impartiality and in a manner consistent with their rights under their stock-holding interests should be regarded as preferential by reason of minor differences in valuations of property distributed.[34]

There is, however, no legislative history which states why such a rule applies to investment companies. The 1983 Report cites an explanation in the CCH Tax Service that this provision was intended "to prevent the preferential distribution of dividends to stockholders in the low brackets".[35]

To solve these problems, instead of using section 561, a RIC should be allowed to deduct all dividends (as defined in section 316) from its taxable income. Thus, a distribution would only need to be payable out of the RIC's earnings and profits in order to be deductible. This would avoid the necessity of considering whether dividends are preferential and would greatly simplify the determination of ICTI as well as address tax concerns about new methods of raising capital for RICs. To prevent any abuse, a deduction for dividends paid (as measured by section 316) would not be allowed if the principal purpose for different dividends paid to shareholders during the taxable year was the avoidance of federal income tax. For example, this would

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34 H.R. Rep. No. 1850, 75th Cong., 3d Sess. (1938)

35 The 1983 Report states that "... serious consideration should be given to whether the cross reference to section 561 is desirable and whether it should not be sufficient that the RIC pay taxable dividends to its stockholders." The 1983 Report then suggested that if such a change was not desirable, the Code be amended to permit different distributions to shareholders solely to permit the participation of some, but not all, shareholders in dividend reinvestment plans of companies in whose shares the RIC invested.

prevent a RIC from deliberately paying higher dividends to tax-exempt shareholders than to non-exempt shareholders.

With respect to shareholder fairness, the 1940 Act basically restricts open-end investment companies to one class of stock. Closed-end companies are restricted to one class of senior security which can have separate series so long as such series are not entitled to preferences with respect to liquidation rights, redemption rights or dividends. These rules should serve to adequately protect investment company shareholders. Moreover, as discussed above, the Committee believes investor protection is best left in the hands of the SEC, the agency charged with investor protection.

A second problem in computing the dividends-paid deduction involves closed-end RICs that have dividend reinvestment plans (“DRIP”s). The typical DRIP provides that if the RIC's shares are trading in the market at a discount to net asset value (“NAV”) then the DRIP agent (usually a bank) will use the dividends that would otherwise be paid to DRIP participants to purchase shares in the open market. This aspect of the DRIP raises little problem. The typical DRIP will also provide, however, that if the RIC's shares are trading at a premium to NAV then new shares will be issued to DRIP participants at a price equal to NAV and a discount to fair market value of no greater than five percent.[36]

The problem arises when the RIC must determine the amount of the dividend distribution. Under section 301 and a series of published rulings under subchapter C,[37] the amount of the distribution to shareholders is the fair market value of the shares distributed. On the other hand, section 1.305-l(b)(2) provides that where a corporation that normally distributes its earnings and profits, such as a regulated investment company, declares a dividend pursuant to which the shareholders may elect to receive either money or stock of the distributing corporation of equivalent value, the amount of the distribution of stock is considered to be equal to the amount of money that could have been received instead. In at least one private letter ruling, the Service has applied this latter rule to a DRIP.[38]

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[36] The five percent discount results from the holding in Rev. Rul. 83-117, 1983-2 C.B. 98 that a discount of no more than five percent in a dividend reinvestment plan offered by a REIT did not result in a preferential dividend because the plan was available to all shareholders and the discount (which was designed to pass through to shareholders underwriting and other cost savings of the plan) resulted in relatively minor differences in distributions to similarly situated taxpayers.

[37] See, e.g., Rev. Rul. 76-53, 1976-1 C.B. 87; Rev. Rul. 78-375, 1978-1 C.B. 130.

[38] Private Letter Ruling 8708005 (November 21, 1986); but see Private Letter Ruling 8722060 (March 2, 1987) and Private Letter Ruling 8812062 (December 28, 1987).

If the dividend to the DRIP participants is the fair market value of the shares distributed then an over-distribution may result. For example, assume that a RIC has 100 shares outstanding; 50 shares participate in the DRIP. During the taxable year the RIC earns $100. Further assume that on December 31, it declares and pays a dividend of $1 per share. If on December 31 its stock price is $10.50 but its NAV per share is $10 the RIC will issue five new shares to the DRIP participant. The value of the shares distributed is $52.50 and therefore the amount of the distribution is $52.50. Total distributions during the year are $102.50 ($50 + $52.50). Since the RIC has only $100 of earnings and profits under section 301 the non-DRIP participant is considered to receive a dividend distribution of $48.78 (100/102.50 x $50) and a return of capital equal to $1.22. When the non-DRIP participant sells its shares it recognizes $1.22 of gain. If the RIC is a tax-exempt fund, $1.22 of the non-DRIP participant's tax-exempt income has been converted into capital gain. Alternatively, since section 852(c) disallows deductions not allowed in computing taxable income in computing a RIC’s earnings and profits, the $1.22 may be taxed to the non-DRIP participant as ordinary income rather than tax-exempt income.

Currently, we understand that different fund groups take different approaches to the problem; some treat the amount of the distribution as the fair market value of the stock distributed while others treat the amount of the distribution to DRIP participants as the amount of cash distributed to non-DRIP participants.

The simple way to solve this problem is to treat the DRIP participant and the non-DRIP participant as receiving dividends equal to the amount of cash distributed. Although this may result in a slight deferral for the DRIP participant we think the benefits of simplicity far outweigh any potential revenue loss. This was the judgment originally made when section 1.305-1(b)(2) was adopted and a revenue ruling clarifying that the regulation applies as well to closed-end funds would be consistent with that earlier judgment.

(ii) Qualification Provisions

Several of the qualification provisions are quite simple, but others are less so. Thus, the structural tests in section 851(a) are easily complied with. The 90 percent test in section 851(b)(2) is also easily complied with, particularly after the 1986 Act's expansion of the types of qualifying income to parallel the 1940 Act definition of securities and to permit other “directly related” income to qualify. This test is also fairly easy to comply with because of the 10 percent safe harbor for non-qualifying income, a safe harbor that is rarely fully used.

The asset diversification tests are relatively straight forward except when derivative financial instruments are considered.

For example, there has been continuing uncertainty over the classification of options, futures, and forward contracts both with respect to valuation[39] and with respect to the identity of the issuer.[40]

To solve these uncertainties, we think that several amendments should be made to the Code. First, for valuation purposes, all options should be treated as securities whether or not they are securities under the 1940 Act. Therefore, the option's value would be its fair market value, i.e., the price for which it could be sold on the valuation date. An option written by a RIC, whether a put option (an option to sell property) or a call option (an option to acquire property) would be disregarded for this purpose, subject to the overall limit on a RIC's obligations discussed below.

[39] The Service has not issued any published guidance on how futures, options, or forwards should be valued for purposes of section 851(b)(4). In GCM 39316 (December 21, 1984) the Service held that (i) the value of a futures contract is the "value of the contract" rather than the amount paid on margin, (ii) the value of a purchased option is the value of the option itself without regard to the value of the property underlying the option, and (iii) the value of a written option is the total value of the underlying property that is the subject of the option, apparently without regard to the price the option holder would have to pay to acquire the property. The Service also ruled that a futures contract or option that hedges an investment in property or that is covered (e.g., a "covered call") would be ignored for purposes of the diversification test. See also GCM 39565 (October 17, 1986), and GCM 39700 (March 7, 1988).

[40] The uncertainty about the identity of the issuer of such derivative instruments was described in the 1983 Report.

Second, futures and forward contracts would also be treated as securities and valued according to their fair market value. This would be the amount that the RIC would receive if it closed out the futures contract at the close of trading on the valuation date. Short futures positions would also be subject to an overall limit.

In order to limit the favorable tax treatment for RICs to investment vehicles designed to purchase securities, it may be appropriate to place an overall limit, perhaps a small percentage (e.g., 25 percent) of the RIC's total portfolio fair market value on the valuation date, on short positions, including call options written by the RIC, put options acquired by the RIC and short positions in futures and forwards, and other positions, such as put obligations written by the RIC under which a RIC could be obligated. The value of the RICs obligation for this purpose would be the excess, if any, of the value of property that the RIC would have to sell under a call option written by the RIC or a put option acquired by the RIC, or deliver under a futures or forward contract if the position were closed at the end of trading on the valuation date over the amount the RIC would receive under the option or contract. In the case of a put obligation written by the RIC, the value of the RIC's obligation would be the excess, if any, of the amount the RIC would be required to pay pursuant to the put obligation (the strike price) over the value of the property the RIC would receive under the put obligation, as if it had settled at the end of trading on the valuation date. The rule would not apply to positions that the RIC could demonstrate (through identification or otherwise) were hedges to long positions in the RIC's portfolio or that were “covered” by securities held by the RIC, and put options written by a RIC could be netted with put options acquired by the RIC in the same property. As with the current diversification tests, a cure rule would apply to allow the RIC to cure any violation within 30 days after the valuation date.

Third, in determining the issuer of an option, futures or forward contract, such instruments would be divided into two categories. The first category involves options or futures with respect to property that itself has an issuer. The issuer of the option or futures contract in this case would be the issuer of the underlying property. For example, the issuer of an option on IBM stock would be IBM, rather than the exchange that actually writes the option. As another example, the issuer of an index option would be each issuer on whose securities or stock the index was based. Thus, the issuer of an S&P 100 option would be the 100 companies whose stock makes up the S&P 100. This set of rules is consistent with the private ruling position of the Service.[41] This type of property would be tested under the

[41] G.C.M. 39708 (March 14, 1988). No published guidance has yet been issued.

normal section 851(b)(4) diversification tests, modified as suggested above.

The second category of derivative instruments for diversification purposes involves options, futures, or forwards on property that does not itself have an issuer. This type of contract would include foreign currencies. In this case, the issuer would be considered different for each class of property. For example, Japanese yen would be considered a separate class of property with a separate issuer. A second set of diversification rules would apply to this property. Under these rules, the RIC could invest a substantial amount of its assets (e.g., between 50 and 75 percent) in options, futures or forwards on any one class of property. Short positions in such “category two” property, other than hedges as described above, would be limited to a small percentage (e.g., 25 percent) of the RIC's assets.

(iii) Reporting to the Service and Shareholders

The current system is effective in permitting clear information to be reported to the Service and to shareholders. The basic shareholder reporting on Form 1099 is relatively straightforward (with the attendant difficulties of all Form 1099's). One exception, however, exists for fiscal year funds that must estimate the Form 1099 amounts and then amend such forms if their fiscal year results prove the form wrong. As long as RICs have non-calendar taxable years this will continue to be a problem. One suggestion here would be to not require a RIC to amend Form 1099 unless the error resulted in a substantial understatement of income to the RIC shareholder.

C. Re-Creating the Effects of Direct Investing

Our second test of current law is how well it recreates the effects of direct investing. In general, a RIC's taxable income is accurately reported to shareholders under the current system. All income at the RIC level is subject to tax in the hands of the shareholders or at the RIC level itself. Subchapter M, however, falls short in accurately treating an investor as though it made the investment directly in the underlying securities held by the RIC. One example of such a discrepancy pointed out in the 1983 Report is that short-term capital gains do not flow through to investors as such. This is important not only for U.S. investors with capital losses but also for foreign investors that would not be taxed on such short-term gains.

A second example of such a difference arises in connection with the portfolio interest exemption under sections 871(h) and 881(c). Because there is no affirmative Code provision permitting portfolio interest pass-through, a RIC serves as a negative converter of portfolio interest. This has led to increased utilization of (i) direct investment by some foreign investors, (ii) the use of foreign investment companies, domestic or foreign grantor trusts and domestic or foreign partnerships to invest in U.S. debt instruments. Thus, for example, only the unadvised foreign investor will invest in mortgage-backed securities through a U.S. RIC. Instead, billions of dollars of money for this market has been raised from foreign investors using offshore investment companies. This makes little sense from a policy standpoint if the goal of the RIC tax system is to treat the investor as though it invested directly. It makes much less sense when the net effect is to drive foreign investors investing in U.S. markets to unregulated offshore jurisdictions.

The Congress could help the flow of foreign investment into such obligations by authorizing pass-through treatment of portfolio interest where the RIC invests in obligations that would produce portfolio interest if held directly by the RIC shareholder.

To cure these problems, the Code should be amended to permit flow-through of portfolio interest, income on bank deposits, discount income on short-term debt instruments and other interest.[42]

To make the section 881(c)(3) limitations on the definition of portfolio interest apply properly we would recommend an overall anti-avoidance rule that would apply to a RIC formed or availed of to avoid the section 881(c)(3) restrictions.

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[42] A RIC would be required to withhold from dividends paid to a shareholder that would otherwise be considered a flow-through of portfolio interest, if that shareholder failed to provide the RIC with a Form W-8. Similarly, a reduced rate of withholding would apply to dividends representing interest other than portfolio interest, income on bank deposits, and discount income on short-term debt instruments only for shareholders that provided the RIC with a Form 1001.

anti-avoidance rule would apply, for example, to a RIC that was formed by a small group of foreign banks to make loans to U.S. corporations. The anti-avoidance rule would be implemented through Treasury regulations. Because of the broad scope of any anti-avoidance rule, such regulations should be prospective to allow investors to use the general rule with confidence before regulations are issued. Without a clear statement of prospective application there may be concern that any bank investing in shares of a RIC before regulations are issued would run afoul of the anti-avoidance regulations. This, in turn, could render the portfolio interest pass-through provision difficult to administer for all investors until regulations are issued.

Another incomplete flow-through exists with respect to interest on U.S. government bonds. This was addressed in the 1983 Report. As was true then, state law is still inconsistent on whether and when interest on U.S. government bonds flows through to shareholders. Although cases in several states have upheld flow-through treatment for RICs, the process of proving the principle in all states by litigation would be time-consuming and may lead to different results in different states.[43] The end

[43] To avoid the state taxation of interest on U.S.government bonds, certain investment funds are structured as limited partnerships. This is not an optimal solution because (i) tax accounting and reporting for the fund and the investors are more complex than with a RIC and (ii) the rules that the Treasury and Service intend to apply to investment funds do not apply, but rather the partnership rules (which are both more restrictive in part and less restrictive in part) apply.

result in states that do not permit a pass-through is indirect state taxation of interest that Congress has dictated should be exempt from state taxation.

As in 1983, we recommend that the Code be amended so that the character of U.S. Treasury obligation interest flows through to shareholders. Thus, RIC dividends would be treated as interest on U.S. government bonds to the extent derived from such interest. Although this is important primarily for state tax purposes, because Treasury obligation interest is portfolio interest even to a bank lending in the ordinary course of business it would be helpful in re-creating the effect of direct investment for foreign shareholders as well.

Additionally, we think that the current restrictions on passing through tax-exempt income and foreign source income should be eliminated. It does not make any sense to allow a complete flow-through for some types of income (e.g., section 854 and section 852(b)(3)) but to restrict such treatment for tax-exempt income and foreign source income (and foreign tax credits). The flow-through of dividends-received deduction income and capital gain works well without a 50 percent asset threshold which would indicate that such thresholds are unnecessary with respect to other types of income which would be specially treated if received directly by the RIC shareholder. Sophisticated computer systems now exist (and are used routinely by RICs and their advisors) that can accurately compute and report exact amounts of tax-exempt and foreign source income to shareholders. Alternatively, if a complete flow-through of foreign source income is not desirable, then all foreign securities (rather than merely foreign corporate securities) should be considered in determining qualification for the section 853 50 percent test.

One other incomplete flow-through exists for original issue discount ("OID") on obligations that a RIC owns. This non-cash income on taxable or tax-exempt debt instruments must nevertheless be distributed to shareholders to meet the section 852(a)(1) 90 percent distribution requirement. Currently, this is done by distributing cash raised through selling assets or borrowing or by giving shareholders a right to take dividends in stock or cash, resulting in a dividend under section 305 even for shareholders that elect stock. This latter mechanism relies on investors choosing stock to emulate the effect of investment in zero coupon bonds. Moreover, the procedure seems unnecessarily cumbersome.

To solve this problem, we recommend that the Code be amended to permit a RIC to use a mechanism for OID like that used for retained capital gains in section 852(b)(3)(D). This would involve the RIC paying a corporate level tax on the OID at the RIC level. A shareholder would be required to include in gross income the full amount of the OID (under a designation rule similar to that in section 852(b)(3)(D)(i)) and would be entitled to claim a tax credit for its share of the RIC level tax.[44] The

[44] The credit would be refundable in the case of a tax-exempt investor or a foreign investor. Consideration should be given to permitting an investor to certify its status to the RIC (which could offset its tax liability by the total tax attributable to such shareholders). A second class of shares for tax exempt or foreign investors may be necessary to ensure that such a system works fairly.

shareholder's basis would be increased by 66 percent of the amount included under a rule similar to section 852(b)(3)(D)(iii).

Such a rule for OID would permit RICs to invest in OID instruments and would permit shareholders to invest in RICs that mimic the effect of investment in OID instruments. From an economic standpoint this rule would allow investors to have the benefits of expert management and economies of scale afforded by use of an investment company.

The concern discussed above applies not only to OID, but in fact, to all forms of non-cash income. The Committee believes, however, that, because of the difficulty of defining non-cash income, a general rule for non-cash income may be difficult to administer and might be subject to abuse. Nonetheless, the relief suggested above for RIC's that have income from the accrual of OID should also be available for three other specified classes of non-cash income, (i) the excess of the income recognized under section 1293 from a qualified electing fund (“QEF”) over distributions from the QEF, (ii) the excess of the income recognized under section 951 from a controlled foreign corporation (a “CFC”) with respect to which the RIC is a “United States shareholder” over distributions received by the RIC from the CFC that are excluded from gross income under section 959,[45] and (iii) as a proxy for actual non-cash income, that portion of the taxable income recognized under section 860C(a) by a RIC that is an excess inclusion within the meaning of section 860E(c). The current inclusion aspects of the QEF rules, the CFC rules and the excess inclusion rules (or more generally section 860C(a)) are all intended to cause investors to pay tax currently on income as it accrues whether or not it is distributed to them. The Committee does not believe any goal of the tax law is served by requiring a RIC to distribute to its shareholders cash from other sources with respect to an investment where, if held directly, the investors would recognize non-cash income.

D. Flexibility

Our final yardstick for measuring the RIC tax rules is flexibility. For example, the 1986 Act made the RIC tax rules far more flexible with two key amendments to the 90 percent test in section 851(b)(2). First, the types of gains qualifying for 90 percent test purposes were expanded to define the term “securities” in section 851(b)(2) as it is defined in section

[45] Although RICs typically do not own the necessary 10 percent of a foreign corporation's voting stock, there may be cases where this occurs, particularly in the case of so-called “country” funds.

2(a)(36) of the 1940 Act. This gives a RIC what is usually a clear test of whether gain on a particular asset qualifies for 90 percent test purposes. Second, a broad category of “other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in ... stock, securities, or currencies” was added. This greatly reduces the uncertainty about qualifying income so long as such income is earned in the normal course of a RIC’s investment activities. As such, it will allow a RIC to earn income in its investment activities without undue concern about whether a particular item of such income qualifies.[46]

The Committee believes that there are still some improvements that could be made to make the RIC tax rules more flexible. First, the Service should publish a ruling that income from swaps, caps, collars and floors that are used to hedge a RIC’s portfolio is income “derived with respect to its business of investing in such stock, securities, or currencies.”[47] Although this result seems apparent under the revised statute,

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[46] For example, before the 1986 Act a commitment fee earned for agreeing to make a loan may not have been qualifying income under the 90 percent test applicable to RICs. This was true even though such a fee was specifically qualifying income for a REIT under section 856(c)(2)(G) and section 856(c)(3)(G). After the 1986 Act, such an amount would qualify under the section 851(b)(2) test if derived from the RICs business of investing in securities.

[47] Compare, Treasury Regulation 1.864-2(c)(i) (“the effecting of transactions in stocks or securities includes ... any other activity closely related thereto ....”).

the volume of these activities by RICs may be substantial and a blanket rule would eliminate any remaining uncertainty as a reason not to use such hedging tools.

Second, as noted above, the computation of ICTI should be “de-linked” from section 561 and the preferential dividend rules of section 562(c). As described above, we believe this would enable a RIC to use newer, more sophisticated capital structures which ultimately benefit the RIC’s shareholders.

Third, while the 1986 Act clarified the section 851(b)(2) 90 percent test with respect to options and futures, it failed to make parallel changes in the section 851(b)(4) diversification tests. We think that applying our proposed changes set forth in the previous section to the diversification tests would improve the certainty with which a RIC applies those tests to options, futures and forwards and remove tax uncertainty as a reason to avoid using such instruments, particularly as hedging devices.

Fourth, a statutory amendment should be considered which would provide relief from the section 851(b)(4) diversification tests during a RIC's first taxable year. Such a rule would be useful primarily in avoiding inadvertent RIC disqualification during a short first taxable year. For example, under a published ruling of the Service,[48] in a short taxable year the section 851(b)(4) asset tests are made on dates that correspond to the normal quarter ends for the RIC's taxable year. A calendar year RIC that closes its initial public offering on

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[48] Rev. Rul. 80-50, 1980-1 C.B. 146.

September 30 must invest on that one day in sufficiently diversified investments to meet the section 851(b)(4) test because September 30 would be a test date in its first taxable year. To solve this problem, we would suggest a rule that for an initial taxable year as a RIC, the section 851(b)(4) test need be met only on the last day of the taxable year, rather than on a quarterly basis. This rule would improve investment flexibility for a RIC during its initial taxable year significantly without compromising the goal of requiring that RICs maintain passive investment portfolios.

Fifth, the current section 851(b)(4) diversification tests should be relaxed to allow the 50 percent basket of section 851(b)(4) to be filled with securities that comprise 10 percent (rather than five) of the value of the RIC's assets. The five percent of value restriction is of particular concern to double or triple tax exempt RICs that invest in tax-exempt obligations of one state. There may be insufficient debt instruments issued by different tax exempt issuers in the state that are of investment quality. In this case, the diversification test has an effect opposite of what is intended: the RIC will be forced to purchase debt instruments of a lower credit quality to achieve a "diversified" portfolio.[49] assets in the securities of seven companies is still substantially diversified and we do not believe that the tax goal of passivity (including ensuring the RIC does not act as a holding company) would be adversely affected by such a rule particularly since the RIC would still be limited to 10 percent of an issuer's voting securities in meeting the 50 percent test of section 851(b)(4)(A).

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49 Consideration could also be given to expanding the definition of "Government securities" to include securities of state and local governments and agencies and instrumentalities thereof (except, perhaps, for "private activity bonds"). The goal of the tax diversification test, to ensure the passivity of RICs, would not be frustrated, for example, by permitting a RIC to invest in an undiversified pool of municipal bonds because no matter how concentrated its portfolio, a RIC cannot engage in the trade or business of operating a municipality. It might be thought that limiting "Government securities" to securities of the United States and its agencies and instrumentalities is necessary to protect investors because securities of other governments are not as risk-free as obligations of the United States. In this regard the Committee notes that (i) many "Government securities" are subject to substantial market risk even if they have little or no credit risk and (ii) the 1940 Act would not prohibit an investment company from investing in a non-diversified pool of state and local obligations and the Committee believes that the tax law should not prohibit, on investor protection grounds, that which is permitted under the 1940 Act.