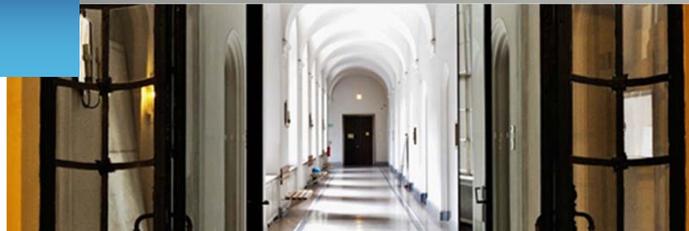


The RIC Modernization Act A Milestone for the Fund Industry



The Regulated Investment Company Modernization Act of 2010 (the “Act”), which was signed into law by President Obama on December 22, 2010, makes changes to a number of technical rules related to the tax treatment of regulated investment companies (“RICs”), including open-end mutual funds, closed-end funds, and most exchange-traded funds. Prior to the enactment of this legislation, the statutory framework governing RICs had not been meaningfully updated since the passage of the Tax Reform Act of 1986. BlackRock, along with other asset managers and trade associations representing the fund industry, supported Congress’s efforts to reform and modernize these laws. We share the view expressed during recent Congressional testimony by William Paul, a representative of the Investment Company Institute, that “the changes made by the Act benefit millions of fund investors by improving the efficiency of fund investment structures, reducing disproportionate tax consequences for inadvertent errors, and minimizing the need for amended tax statements and amended tax returns.” In this paper, we summarize the major provisions of the Act, highlighting areas of notable improvement.

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William Paul, Congressional Testimony for Investment Company Institute, 15 July 2010

Background

Subchapter M of the Internal Revenue Code of 1986 provides the framework for the special tax rules governing RICs and their shareholders. First, to qualify as a RIC under Subchapter M, an investment company must be registered under the Investment Company Act of 1940. As such, these types of funds are subject to regulatory oversight by the Securities and Exchange Commission. Second, a RIC must derive at least 90 percent of its income from qualified sources, such as dividends, interest, and capital gains. Third, it must distribute at least 90 percent of its net taxable income. Finally, a RIC must satisfy certain asset

The Regulated Investment Company Modernization Act of 2010 (Public Law No: 111-325)

TITLE I — Capital Loss Carryovers of Regulated Investment Companies

TITLE II — Modification of Gross Income and Asset Tests of Regulated Investment Companies

TITLE III — Modification of Rules Related to Dividends and Other Distributions

TITLE IV — Modifications Related to Excise Tax Applicable to Regulated Investment Companies

TITLE V — Other Provisions

diversification requirements. A fund that meets the requirements to be treated as a RIC is generally allowed to deduct from its taxable income the distributions that it pays to its shareholders, effectively avoiding double taxation by passing through its net income and gains to its shareholders free of tax at the RIC level.

Over the past quarter century, the fund industry has undergone significant evolution. New fund structures, such as fund of funds, multiple-share classes, and master-feeders, were developed. Furthermore, as investor demand for a broader range of products grew, investment philosophies and styles became more diverse. As the industry changed, many of the tax rules applicable to RICs became obsolete, created administrative burdens, or caused uncertainty.

Proposals to modernize various aspects of the technical rules applicable to RICs were made during previous sessions of Congress. The bill that was ultimately passed was introduced during the 111th Congress by Representative Charles Rangel (D-NY) on December 16, 2009, about one year prior to its enactment. The Act contains almost all of the provisions included in the bill’s original text except for those that address a RIC’s ability to invest directly in commodities and those related to investments in foreign currencies. Reportedly, after several senators expressed concerns about the potential impact of these proposals, they were dropped from the bill. It is unclear whether they will be re-considered at a later date.

Summary of Major Provisions

In most cases, the Act's provisions are effective for RIC taxable years beginning after the date of enactment.

Title I: Capital Loss Carryovers

The Act makes significant improvements to the capital loss carryover rules for RICs to better align them with the rules applicable to individuals. Under prior law, a RIC was permitted to carry over a capital loss incurred on portfolio transactions. However, the carryover expired after eight years. Furthermore, a loss was carried over to a subsequent tax year as a short-term capital loss regardless of whether it was initially realized as a long-term capital loss. The Act eliminates the eight-year carryover period, allowing RICs to carry their capital losses forward indefinitely (for losses arising in taxable years beginning after the date of enactment) and dictates that losses retain their character as either short-term or long-term.

Title II: Modification of Gross Income and Asset Tests

A RIC must annually satisfy a gross income test and an asset diversification test. Under prior law, a fund that failed either of these tests would lose its RIC status and be taxed as a corporation, currently at a maximum rate of 35 percent (resulting in double taxation). The Act reduces the severity of this penalty for funds that inadvertently fail to satisfy either the gross income test or the asset diversification test by providing mechanisms for a RIC to cure minor infractions.

To pass the gross income test, a fund must derive at least 90 percent of its annual income from qualified sources, such as dividends, interest, and capital gains. Under prior rules, if a fund failed to comply with this provision, by even one dollar, it lost its RIC status. The Act allows a RIC to cure an inadvertent failure to comply by paying a tax equal to the amount of income by which the RIC failed.

To pass the asset diversification test, a RIC must diversify its holdings at the end of each quarter of its taxable year in accordance with the provisions specified by the Internal Revenue Code. Failure to satisfy the asset diversification test results in a loss of RIC status. Under the Act, if a fund fails the test by a *de minimis* amount and returns to compliance within a six-month period, the RIC will be considered to have satisfied the test and will not lose its RIC status. If the fund fails by more than a *de minimis* amount and the failure is due to reasonable cause, the fund can avoid disqualification as a RIC by notifying the Internal Revenue Service (IRS) of the failure, disposing of the assets causing the failure, and paying an excise tax based on the net income from the assets causing the failure during the period.

Title III: Modification of Rules Related to Dividends and Other Distributions

The legislation modifies a series of rules applicable to RIC dividends and other distributions, eliminating obsolete reporting

requirements, minimizing the need for amended tax filings, providing greater flexibility, and reducing uncertainties in the application of particular tax rules.

Modification of dividend designation requirements and allocation rules. The Act repeals the requirement that a RIC send written designation notices to its shareholders within sixty days of the end of the RIC's taxable year to designate capital gain dividends, exempt-interest dividends, foreign tax credits, credits for tax credit bonds, qualified dividend income, the corporate dividends received deduction, interest-related dividends, and short-term capital gain dividends. The characteristics of such passed-through items are already routinely reported to shareholders on IRS Form 1099s or other account statements.

The Act also coordinates allocation rules applicable to RICs with taxable years that overlap two calendar years ("non-calendar year RICs"). Under prior rules, non-calendar year RICs that overdistributed their net capital gains over the course of a taxable year were required to send amended tax forms to shareholders. Rather than forcing funds and shareholders to file amended returns for the prior calendar year, the Act generally allows RICs to first reduce capital gain dividends in the subsequent calendar year by the amount of the excess capital gain dividends reported in the prior calendar year. Similar rules apply to exempt-interest dividends and to interest-related dividends and short-term gain dividends for non-U.S. shareholders. We expect the change to minimize the number of situations in which RICs are required to amend year-end tax information, ultimately reducing administrative burdens for shareholders.

Distributions made by a RIC in excess of its earnings and profits are generally treated as a nontaxable return of capital. Under prior law, if a RIC made a return of capital distribution, it was required to allocate the return of capital pro rata over all distributions made during its taxable year. For RICs with taxable years other than the calendar year, this rule often resulted in amounts previously reported to shareholders as taxable dividends being retroactively treated as returns of capital, requiring RICs to send amended tax forms to shareholders. The Act amends this rule by mandating that a RIC's earnings and profits be allocated first to distributions made prior to December 31 and then to distributions made after December 31. We expect this change to reduce the need for funds to send amended IRS Form 1099s to shareholders when reporting returns of capital distributions and the need for shareholders to file amended tax returns.

Earnings and profits. The Act allows a RIC to take into account certain deductions associated with tax-exempt income when calculating its earnings and profits. Under prior law, these types of deductions were not permitted in the calculation of earnings and profits. Accordingly, when a municipal bond fund distributed amounts in excess of its net tax-exempt income, such

distributions were required to be reported to shareholders as taxable dividends. Under the Act, shareholders in a municipal bond fund that distributes in excess of its net tax-exempt income will now be treated as having received a return of capital distribution, not, as under prior law, a taxable dividend.

Pass-thru of exempt-interest dividends and foreign tax credits in fund of funds structures. A RIC is allowed to pass through to shareholders its tax-exempt interest income and foreign tax credits only if two requirements are met. To pass through its tax-exempt interest, at least 50 percent of the value of its assets must consist of tax-exempt bonds at the end of each quarter of a RIC's taxable year. To pass through its foreign tax credits, at least 50 percent of the value of its assets at the close of its taxable year must consist of securities issued by foreign corporations. In a fund of funds structure, an upper-tier RIC holds stock in other RICs and therefore, it failed to meet the 50 percent asset requirements under prior law. The Act remedies this issue by allowing a RIC to pass through tax-exempt interest income and foreign tax credits if at least 50 percent of its assets at the end of each quarter are invested in other RICs.

Modification of rules for spillover dividends. Under current law, certain dividends paid by a RIC after the end of its taxable year may be taken into account when calculating the dividends paid for that year. In order for a dividend to qualify for this "spillover" treatment, certain restrictive timing requirements must be met with respect to the declaration and payment of such dividend. The Act relaxes some of these timing requirements, providing RICs with greater flexibility in scheduling the payment of spillover dividends.

Distributions in redemption of stock. Under prior law, managers of RICs often encountered difficulty in determining whether a distribution in partial redemption of stock should be treated as an exchange or as a dividend. The Act eliminates this uncertainty and authorizes all publicly offered RICs to treat distributions in redemption of stock as exchanges. Additionally, under the Act, losses incurred by an upper tier fund on the redemption by a fund of funds of shares in an underlying fund will not be subject to the loss deferral rules applicable to transactions between related parties. Under prior law, such losses might have been deferred, while any gains would have been recognized currently.

Repeal of preferential dividend rule for publicly-offered RICs. A RIC is allowed a deduction from its taxable income for the dividends that it pays to its shareholders. Under prior law, to qualify for the dividends paid deduction, a dividend had to be distributed pro rata to shareholders, with no preference to one class over another except to the extent that the class was entitled to a preference. The preferential dividend rule was adopted prior to the enactment of the Investment Company Act of 1940, which contains its own provisions for the protection and equitable treatment of RIC shareholders. The Act repeals the now obsolete preferential dividend rule for publicly offered RICs.

Elective deferral of certain late-year losses. A RIC is required to distribute substantially all of its net ordinary income (measured through December 31) and its net capital gains (measured through October 31) by December 31 of each year. A RIC with a taxable year other than the calendar year may suffer losses subsequent to December which may change the amounts of taxable income and gains for its taxable year, impacting the amounts that were previously reported on shareholder tax reporting and cost basis statements. The Act addresses this issue by providing a RIC with the flexibility to treat a post-December 31 ordinary loss (or a post-October 31 capital loss) as arising on the first day of the RIC's next taxable year. This provision will reduce the frequency of cases in which a RIC is required to send amended tax statements to shareholders.

Exception to holding period requirement for certain regularly declared exempt-interest dividends. The Act streamlines the process of reporting cost basis data to shareholders in municipal bond funds. Under prior rules, if a shareholder sold shares held for six months or less, any loss on the sale would be disallowed to the extent of the amount of the exempt-interest dividends received with respect to those shares. The Act eliminates this loss disallowance with respect to regular dividends paid by RICs that declare exempt-interest dividends on a daily basis in an amount equal to at least 90 percent of their net tax-exempt interest and distribute such dividends on a monthly or more frequent basis.

Title IV: Modifications Related to Excise Tax

Under current law, a RIC is subject to an excise tax to the extent that it does not distribute substantially all of its income by December 31 each year. The Act makes several technical modifications to the excise tax rules applicable to RICs.

Under prior law, a RIC was exempt from excise tax distribution requirements if all of its shareholders were tax-exempt trusts of qualified retirement plans or segregated accounts underlying variable insurance contracts. The Act extends this exemption to RICs that have as shareholders additional types of retirement plans and section 529 plans. The Act revises the excise tax requirement to treat all ordinary income or loss attributable to the sale or exchange of assets arising after October 31 as arising on the first day of the next calendar year. The Act permits a RIC that pays estimated tax to take such payments into account when calculating its annual distribution requirement or excise tax liability for the calendar year in which such payments are made. Lastly, the Act increases the minimum distribution requirement for capital gain net income from 98.0 percent to 98.2 percent.

Title V: Other Provisions

Repeal of the assessable penalty component of the deficiency dividend provision. The Act lessens the severity of the consequences for paying a deficiency dividend by removing the requirement that a RIC pay, in addition to an interest charge, a supplemental penalty. Under prior rules, the supplemental

penalty was equal to the lesser of the amount of the interest charged or 50 percent of the amount of the deficiency dividend.

Modification of sales load basis deferral rule. The Act revises the sales load basis deferral rule, effectively eliminating the possibility that this rule will require shareholders to amend individual income tax returns in the future. Under prior rules, in certain situations, shareholders in a RIC were required to increase their basis in RIC stock by the amount of a load charge that was paid with respect to previously-owned RIC stock. For taxable years beginning after the date of enactment, the Act limits this rule to cases in which a shareholder acquires new RIC stock before January 31 of the calendar year following the year

of the disposition of the initial RIC stock that generated the load charge.

Conclusion

It is noteworthy that during a period marked by contentious political debate, this legislation, which represents the first major reform of its kind in a quarter century, received broad bipartisan support. In our view, the changes contained in the Act will reduce administrative burdens and promote efficiency, providing real benefits to fund investors. We would encourage lawmakers to revisit the dropped provisions, which dealt with a RIC's ability to invest in commodities and foreign currencies, in the future.

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