TECHNICAL EXPLANATION OF H.R. 4337, THE "REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010," FOR CONSIDERATION ON THE FLOOR OF THE HOUSE OF REPRESENTATIVES

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of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of H.R. 4337, the "Regulated Investment Company Modernization Act of 2010," for consideration on the floor of the House of Representatives. Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of H. R. 4337, the "Regulated Investment Company Modernization Act of 2010," for Consideration on the Floor of the House of Representatives*, (JCX-49-10), September 28, 2010. This document can also be found on our website at www.jct.gov.

I. OVERVIEW OF REGULATED INVESTMENT COMPANIES

In general, a regulated investment company ("RIC") is an electing domestic corporation that either meets (or is excepted from) certain registration requirements under the Investment Company Act of 1940,[2] that derives at least 90 percent of its ordinary income from specified sources considered passive investment income,[3] that has a portfolio of investments that meet certain diversification requirements,[4] and meets certain other requirements.[5]

Many RICs are "open-end" companies (mutual funds) which have a continuously changing number of shares that are bought from, and redeemed by, the company and that are not otherwise available for purchase or sale in the secondary market. Shareholders of open-end RICs generally have the right to have the company redeem shares at "net asset value." Other RICs are "closed-end" companies, which have a fixed number of shares that are normally traded on national securities exchanges or in the over-the-counter market and are not redeemable upon the demand of the shareholder.

In the case of a RIC that distributes at least 90 percent of its net ordinary income and net tax-exempt interest to its shareholders, a deduction for dividends paid is allowed to the RIC in computing its tax.[6] Thus, no corporate income tax is imposed on income distributed to its shareholders. Dividends of a RIC generally are includible in the income of the shareholders; a RIC can pass through the character of (1) its long-term capital gain income, by paying "capital gain dividends" and (2) in certain cases, tax-exempt interest, by paying "exempt-interest dividends." A RIC may also pass through certain foreign tax credits and credits on tax-credit bonds, as well as the character of certain other income received by the RIC.

[2] Secs. 851(a) and (b)(1).

[3] Sec. 851(b)(2).

[4] Sec. 851(b)(3).

[5] Secs. 851 and 852.

[6] Sec. 852(a) and (b).

II. CAPITAL LOSS CARRYOVERS OF RICS

A. Capital Loss Carryovers of RICs (sec. 101 of the bill and sec. 1212(a) of the Code)

Present Law

Limitation on capital losses

Losses from the sale or exchange of capital assets are allowed only to the extent of the taxpayer's gains from the sale or exchange of capital assets plus, in the case of a taxpayer other than a corporation, $3,000.[7]

Carryover of net capital losses

RICs

If a RIC has a net capital loss (i.e., losses from the sale or exchanges of capital assets in excess of gains from sales or exchanges of capital assets) for any taxable year, the amount of the net capital loss is a capital loss carryover to each of the eight taxable years following the loss year, and is treated as a short-term capital loss in each of those years.[8] The entire amount of a net capital loss is carried over to the first taxable year succeeding the loss year and the portion of the loss which may be carried to each of the next seven years is the excess of the net capital loss over the net capital gain income[9] (determined without regard to any net capital loss for the loss year or taxable year thereafter) for each of the prior taxable year to which the loss may be carried.

Corporations other than RICs

In the case of a corporation other than a RIC, a net capital loss generally is treated as a capital loss carryback to each of the three taxable years preceding the loss year and a capital loss carryover the each of the five taxable years following the loss year and is treated as a short-term capital loss in each of those years.[10] The carryover amount is reduced in a manner similar to that described above applicable to RICs. A net capital loss may not be carried back to a taxable year for which a corporation is a RIC.[11]

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[7] Sec. 1211.

[8] Sec. 1212(a)(1)(C)(i).

[9] Capital gain net income is the excess of gains from the sale or exchange of capital assets over losses from such sales or exchanges. Sec. 1222(9).

[10] Sec. 1212(a)(1)(A).

[11] Sec. 1212(a)(3)(A).

Individual taxpayers

If a taxpayer other than a corporation has a net capital loss for any taxable year, the excess (if any) of the net short-term capital loss over the net long-term capital gain is treated as a short-term capital loss in the succeeding taxable year, and the excess (if any) of the net long-term capital loss over the net short-term capital gain is treated as a long-term capital loss in the succeeding taxable year.[12] There is no limitation on the number of taxable years that a net capital loss may be carried over.

Explanation of Provision

In general

The bill provides capital loss carryover treatment for RICs similar to the present-law treatment of net capital loss carryovers applicable to individuals. Under the bill, if a RIC has a net capital loss for a taxable year, the excess (if any) of the net short-term capital loss over the net long-term capital gain is treated as a short-term capital loss arising on the first day of the next taxable year, and the excess (if any) of the net long-term capital loss over the net short-term capital gain is treated as a long-term capital loss arising on the first day of the next taxable year.[13] The number of taxable years that a net capital loss of a RIC may be carried over under the provision is not limited.

Coordination with present-law carryovers

The bill provides for the treatment of net capital loss carryovers under the present law rules to taxable years of a RIC beginning after the date of enactment. These rules apply to (1) capital loss carryovers from taxable years beginning on or before the date of enactment of the provision and (2) capital loss carryovers from other taxable years prior to the taxable year the corporation becoming a RIC.

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

The following example illustrates these rules:

Assume a calendar year RIC has no net capital loss for any taxable year beginning before 2010, a net capital loss of $2 million for 2010; a net capital loss of $1 million for 2011, all of

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[12] Sec. 1212(b). Adjustments are made to take account of the $3,000 amount allowed against ordinary income

[13] For earnings and profits treatment of a RIC's net capital loss, see sec. 302 of the bill.

which is a long-term capital loss; and $600,000 gain from the sale of a capital asset held less than one year on July 15, 2012.[14]

For 2012, the RIC has (1) $600,000 short-term capital gain from the July 15 sale, (2) $2 million carryover from 2010 which is treated as a short-term capital loss,[15] and (3) $1 million long-term capital loss from 2011 treated as arising on January 1, 2012. The capital loss allowed in 2012 is limited to $600,000, the amount of capital gain for the taxable year.

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

Effective Date

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

[14] Assume, for purposes of this example, that the provision is enacted in 2010.

[15] The present-law treatment of net capital losses arising in taxable years beginning before the date of enactment continues to apply.

III. MODIFICATION OF GROSS INCOME AND ASSET TESTS OF RICS

A. Income From Commodities Counted Toward Gross Income Test of RICs (sec. 201 of the bill and sec. 851(b) of the Code)

Present Law

A RIC must derive 90 percent of its gross income for a taxable year from certain types of income.[16] These types of income ("qualifying income") are (1) dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended)[17] or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to the business of investing in such stock, securities, or currencies, and (2) net income derived from an interest in a qualified publicly traded partnership.[18]

In general, because direct investments in commodities are not "securities" under section 2(a)(36) of the Investment Company Act of 1940, they do not generate "qualifying income" for purposes of the 90 percent gross income test. Similarly, the IRS has ruled that derivative contracts with respect to commodity indexes are not securities for the purposes of the gross income tests.[19] On the other hand, in a series of private rulings, the IRS has held that certain notes, with payout formulas determined with reference to a commodities index, produce qualifying income for purposes of the gross income test.[20] The IRS also has held that income of a RIC derived from investments in commodities by a wholly owned foreign subsidiary of the RIC is qualifying income for purposes of the gross income test.[21]

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[16] Sec. 851(b)(2).

[17] Section 2(a)(36) of the Investment Company Act of 1940 defines a "security" as "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

[18] A "qualified publicly traded partnership" means a publicly traded partnership (within the meaning of section 7704(b)), other than a publicly traded partnership whose gross income is qualifying income (other than income of another publicly traded partnership). Sec. 851(h).

[19] See Rev. Rul. 2006-31, 2006-1 C.B. 1133.

[20] See, e.g., PLRs 201031007, 200822012, 200705026, 200701020, 200647017, 200637018, 200628001.

[21] See, e.g., PLRs 200936002, 200932007.

The Secretary has the regulatory authority to exclude from qualifying income foreign currency gains which are not directly related to the RIC's principal business of investing in stock or securities (or options and futures with respect to stock or securities).[22]

Explanation of Provision

The provision modifies the qualifying income test to provide that (i) a RIC's gains from the sale or other disposition of commodities and (ii) 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, are qualifying income for purposes of the gross income test. As a result, income earned by a RIC from derivative contracts with respect to commodity indices will be qualifying income for purposes of the gross income test.[23] In general, these changes are not intended to change the present law treatment of RICs' income from foreign currencies. However, because the provision allows RICs to derive qualifying income from investments in commodities (including foreign currencies), the provision repeals the regulatory authority given to the Secretary to exclude certain foreign currency gains from qualifying income.[24]

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

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[22] Sec. 851(b)(3).

[23] Cf. Rev. Rul. 2006-31, 2006-1 C.B. 1133 (holding that a RIC’s income from a derivative contract with respect to a commodity index is not qualifying income for purposes of section 851(b)(2), because the income from the contract is not derived with respect to the RIC’s business of investing in stocks, securities, or currencies.)

[24] The bill contains several conforming amendments to retain the present law definition of qualifying income for purposes of provisions relating to publicly traded partnerships.

B. Savings Provisions for Failures of RICs to Satisfy Gross Income and Asset Tests (sec. 202 of the bill and sec. 851(d) and (i) of the Code)

Present Law

Asset tests

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.[25]

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)).[26]

A RIC meeting both asset tests at the close of any quarter will not lose its status as a RIC because of a discrepancy during a subsequent quarter between the value of its various investments and the asset test requirements, unless such discrepancy exists immediately after the acquisition of any security or other property and is wholly or partly the result of such acquisition.[27] This rule protects a RIC against inadvertent failures of the asset tests that may be caused by fluctuations in the relative values of its assets. A second rule (the "30-day rule") gives a RIC 30 days following the end of a quarter in which it fails an asset test to cure the failure, if the failure is by reason of a discrepancy, between the value of its various investments and the asset test requirements, that exists immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition during such quarter.[28] Failure of any asset test (except where the failure is cured pursuant to the 30-day rule) will prevent a corporation from qualifying as a RIC.

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[25] Sec. 851(b)(3)(A).

[26] Sec. 851(b)(3)(B).

[27] Sec. 851(d).

[28] *Ibid.*

Gross income test

A RIC must derive 90 percent of its gross income from qualifying income.[29] Thus, a RIC meets the gross income test provided its gross income that is not qualifying income does not exceed one-ninth of the portion of its gross income that is qualifying income. For example, a RIC with $90x of gross income from qualifying income can have up to $10x of gross income from other sources without failing the test. Failure to meet the gross income test for a taxable year prevents a corporation from qualifying as a RIC for that year.

Explanation of Provision

Saving provision for asset test failures

The bill provides a special rule for *de minimis* asset test failures and a mechanism by which a RIC can cure other asset test failures and pay a penalty tax. The rule for *de minimis* asset test failures applies if a RIC fails to meet one of the asset tests in section 851(b)(3) due to the ownership of assets the total value of which does not exceed 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. Where the *de minimis* rule applies, the RIC shall nevertheless be considered to have satisfied the asset tests if, within six months of the last day of the quarter in which the RIC identifies that it failed the asset test (or such other time period provided by the Secretary) the RIC: (i) disposes of assets in order to meet the requirements of the asset tests, or (ii) the RIC otherwise meets the requirements of the asset tests.

In the case of other asset test failures, a RIC shall nevertheless be considered to have met the asset tests if: (i) the RIC sets forth in a schedule filed in the manner provided by the Secretary a description of each asset that causes the RIC to fail to satisfy the asset test; (ii) the failure to meet the asset tests is due to reasonable cause and not due to willful neglect; and (iii) within six months of the last day of the quarter in which the RIC identifies that it failed the asset test (or such other time period provided by the Secretary) the RIC (I) disposes of the assets which caused the asset test failure, or (II) otherwise meets the requirements of the asset tests. In cases of asset test failures other than *de minimis* failures, the provision imposes a tax in an amount equal to the greater of (i) $50,000 or (ii) the amount determined (pursuant to regulations promulgated by the Secretary) by multiplying the highest rate of tax specified in section 11 (currently 35 percent) by the net income generated during the period of asset test failure by the assets that caused the RIC to fail the asset test. For purposes of subtitle F, the tax imposed for an asset test failure is treated as excise tax with respect to which the deficiency procedures apply.

These provisions added by the bill do not apply to any quarter in which a corporation’s status of a RIC is preserved under the provision of present law.

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[29] See present-law explanation of section 201 of the bill for a description of qualifying income.

Saving provision for gross income test failures

The bill provides that a corporation that fails to meet the gross income test shall nevertheless be considered to have satisfied the test if, following the corporation's failure to meet the test for the taxable year, the corporation (i) sets forth in a schedule, filed in the manner provided by the Secretary, 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.

In addition, under the bill, a tax is imposed on any RIC that fails to meet the gross income test 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. 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 the amount by which the $15x gross income from sources which are not qualifying income exceeds the $10x permitted under present law.

Calculation of investment company taxable income

Taxes imposed for failure of the asset or income tests are deductible for purposes of calculating investment company taxable income.

Effective Date

The provision applies to taxable years with respect to which the due date (determined with regard to extensions) of the return of tax is after the date of enactment.

IV. MODIFICATION OF RULES RELATED TO DIVIDENDS AND OTHER DISTRIBUTIONS

A. Modification of Dividend Designation Requirements and Allocation Rules for RICs (sec. 301 of the bill and sec. 852(b) of the Code)

Present Law

Capital gain dividends

In general

In general, a capital gain dividend paid by a RIC is treated by the RIC's shareholders as long-term capital gain.[30] In addition, a RIC is allowed a dividend paid deduction for its capital gain dividends in computing the tax imposed on its net capital gain.[31]

A capital gain dividend is any dividend, or part thereof, which is designated by the RIC as a capital gain dividend in a written notice mailed to the RIC's shareholders not later than 60 days after the close of the RIC's taxable year,[32] except that in the event a RIC designates an aggregate amount of capital gain dividends for a taxable year that exceeds the RIC's net capital gain, the portion of each distribution that is a capital gain dividend is only that proportion of the designated amount that the RIC's net capital gain bears to the total amount so designated by the RIC. For example, assume a RIC makes quarterly distributions of $30, designated entirely as capital gain dividends. If the RIC has only $100 of net capital gain for its taxable year, only $25 of each quarterly distribution is a capital gain dividend (i.e., $30 × ($100/$120) = $25).

Other designated items

Exempt-interest dividends

A RIC may designate any portion of a dividend (other than a capital gain dividend) as an "exempt-interest dividend," if at least half of the RICs assets consist of tax-exempt State and

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[30] Sec. 852(b)(3)(B). This provision applies only with respect to RICs which meet the requirements of section 852(a) for the taxable year.

[31] Sec. 852(b)(3)(A).

[32] Sec. 852(b)(3)(C). If there is an increase in the amount by which a RIC's net capital gain exceeds the deduction for dividends paid (determined with reference to capital gain dividends only) as a result of a "determination," the RIC has 120 days after the date of the determination to make a designation with respect to such increase. A determination is defined in section 860(e) as: (1) a decision by the Tax Court, or a judgment, decree, or other order by any court of competent jurisdiction, which has become final; (2) a closing agreement made under section 7121; (3) under regulations prescribed by the Secretary, an agreement signed by the Secretary and by, or on behalf of, the qualified investment entity relating to the liability of such entity for tax; or (4) a statement by the taxpayer attached to its amendment or supplement to a return of tax for the relevant tax year. See Rev. Proc. 2009-28, 2009-20 I.R.B. 1011.

local bonds. The shareholder treats an exempt-interest dividend as an item of tax-exempt interest.[33]

Exempt-interest dividends are defined as any dividend, or part thereof, which is designated by the RIC as an exempt interest dividend in a written notice mailed to the RIC's shareholders not later than 60 days after the close of the RIC's taxable year,[34] except that in the event a RIC designates an aggregate amount of exempt-interest dividends for a taxable year that exceeds the RIC's tax exempt interest (net of related deductions disallowed under sections 265 and 171(a)(2) by reason of the interest being tax exempt), the portion of each distribution that will be an exempt interest dividend is only that proportion of the designated amount that net exempt interest bears to the amount so designated.

Foreign tax credits; credits for tax-credit bonds; dividends received by RIC

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

Dividends paid to certain foreign persons.

Certain dividends paid to nonresident alien individuals and foreign corporations in taxable years of the RIC beginning before January 1, 2010, retain their character as interest or short term-capital gain.[35] These dividends must be designated in a written notice mailed to its shareholders not later than 60 days after the close of the RIC's taxable year. Rules similar to the rules described above relating to capital gain dividends and exempt-interest dividends apply to designated amounts in excess of actual amounts.

Explanation of Provision

Capital gain dividends

Reporting requirements

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

[33] Sec. 852(b)(5)(B).

[34] Sec. 852(b)(5)(A).

[35] Secs. 871(k) and 881(e).

Allocation by fiscal year RICs

The provision provides a special rule allocating the excess reported amount[36] for taxable year RICs in order to reduce the need for RICs to amend Form 1099s and shareholders to file amended income tax returns. This special allocation rule applies to a taxable year of a RIC which includes more than one calendar year if the RIC's post-December reported amount[37] exceeds the excess reported amount for the taxable year.

For example, assume a RIC for its taxable year ending June 30, 2012, makes quarterly distributions of $30,000 on September 30, 2011, December 31, 2011, March 31, 2012, and June 30, 2012, and reports the amounts as capital gain dividends. If the RIC has only $100,000 net capital gain for its taxable year, the excess reported amount is $20,000. Because the post-December reported amount ($60,000) exceeds the excess reported amount ($20,000), the excess reported amount is allocated among the post-December reported capital gain dividends in proportion to the amount of each such distribution reported as a capital gain dividend. Thus, one-half of the excess reported amount (i.e., 1/2 of $20,000 = $10,000) is allocated to each post-December distribution, reducing the amount of each post-December distribution treated as a capital gain dividend from $30,000 to $20,000. Because no excess reported amount is allocated to either of the quarterly distributions made on or before December 31, 2011, the entire $30,000 of each of the distributions retains its character as a capital gain dividend.

If, in the above example, the RIC has only $40,000 net capital gain for its taxable year, the excess reported amount is $80,000. Because the post-December reported amount ($60,000) does not exceed the excess reported amount ($80,000), the excess reported amount is allocated among all the reported capital gain dividends for the taxable year in proportion to the amount of each distribution reported as a capital gain dividend. Thus, one-fourth of the excess reported amount (i.e., 1/4 of $80,000 = $20,000) is allocated to each distribution, reducing the amount of each distribution treated as a capital gain dividend from $30,000 to $10,000.

Other designated items

The provision replaces the other designation requirements described under present law with a requirement that amounts be *reported* by the RIC in written statements furnished to its shareholders.[38]

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

[36] The “excess reported amount” is the excess of the aggregate amount reported as capital gain dividends for the taxable year over the RIC's net capital gain for the taxable year.

[37] The “post-December reported amount” is the aggregate amount reported with respect to items arising after December 31 of the RIC's taxable year.

[38] The bill does not change the method of designation of undistributed capital gain taken into account by shareholders under section 852(b)(3)(D)(i).

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

Effective Date

The provision applies to taxable years beginning after the date of enactment.[39]

[39] Each amendment to a provision relating to qualified dividends of individual shareholders will sunset when the provision to which the amendment was made sunsets pursuant to section 303 of the Jobs and Growth Tax Relief Reconciliation Act. Under present law, these provisions sunset in taxable years beginning after December 31, 2010.

B. Earnings and Profits of RICs
(sec. 302 of the bill and sec. 852(c)(1) of the Code)

Present Law

The current earnings and profits of a RIC are not reduced by any amount that is not allowable as a deduction in computing taxable income for the taxable year.[40]

Application to net capital loss

Thus, under the general rule, the current earnings and profits of a RIC are not reduced by a net capital loss either in the taxable year the loss arose or any taxable year to which the loss is carried.[41] The accumulated earnings and profits are reduced in the taxable year the net capital loss arose.

Application to exempt-interest expenses

Because the general rule denies deductions in computing current earnings and profits for amounts disallowed for expenses, interest, and amortizable bond premium relating to tax-exempt interest,[42] the current earnings and profits of a RIC with tax-exempt interest may exceed the amount which the RIC can distribute as exempt-interest dividends.[43] Thus, distributions by a RIC with only tax-exempt interest income may result in taxable dividends to its shareholders. For example, assume a RIC has $1 million gross tax-exempt interest and $10,000 expenses disallowed under section 265 (and no accumulated earnings and profits and no other item of current earnings and profits). If the RIC were to distribute $1 million to its shareholders during its taxable year (which is $10,000 more than its economic income for the year), $990,000 may be designated as exempt-interest dividends, and the remaining $10,000 is taxable as ordinary dividends.

Explanation of Provision

Net capital loss

The rules applicable to the taxable income treatment of a net capital loss of a RIC apply for purposes of determining earnings and profits (both current earnings and profits and accumulated earnings and profits). Thus, a net capital loss for a taxable year is not taken into account in determining earnings and profits, but any capital loss treated as arising on the first day

[40] Sec. 852(c)(1). The provision applies to a RIC without regard to whether it meets the requirements of section 852(a) for the taxable year.

[41] See sec. 101 of the bill for the treatment of carryovers of a net capital loss under present law and as amended by the bill.

[42] Secs. 171(a)(2) and 265.

[43] For a description of exempt-interest dividends, see explanation of section 301 of the bill.

of the next taxable year is taken into account in determining earnings and profits for the next taxable year (subject to the application of the net capital loss rule for that year).

Exempt-interest expenses

The deductions disallowed in computing investment company taxable income relating to tax-exempt interest are allowed in computing current earnings and profits of a RIC.

In the example under present law, the provision reduces the RIC's current earnings and profits from $1 million to $990,000 and if the RIC were to distribute $1 million to its shareholders during the taxable year, $990,000 may be reported as exempt-interest dividends and the remaining $10,000 is treated as a return of capital (or gain to the shareholder).

Effective Date

The provision applies to taxable years beginning after the date of enactment.

C. Pass-thru of Exempt-interest Dividends and Foreign Tax Credits in Fund of Funds Structures (sec. 303 of the bill and sec. 852(g) of the Code)

Present Law

In a so-called "fund of funds" structure, one RIC ("upper-tier fund") holds stock in one or more other RICs ("lower-tier funds"). Generally, the character of certain types of income and gain, such as capital gain and qualified dividends, of a lower-tier fund pass through from the lower-tier RIC to the upper-tier RIC and then pass through to the shareholders of the upper-tier RIC.

Exempt-interest dividends and foreign tax credits may be passed through by a RIC only if at least 50 percent of the value of the total assets of a RIC consist of tax-exempt obligations (in the case of exempt-interest dividends) or more than 50 percent of the value of the total assets consist of stock or securities in foreign corporations (in the case of the foreign tax credit). Because an upper-tier RIC holds stock in other RICs, it does not meet the 50-percent asset requirements. As a result, it may not pass through these items to its shareholders, even though the items were passed through to it by a lower tier RIC meeting these requirements.

Explanation of Provision

Under the provision, in the case of a qualified fund of funds, the RIC may (1) pay exempt-interest dividends without regard to the requirement that at least 50 percent of the value of its total assets consist of tax-exempt State and local bonds and (2) elect to allow its shareholders the foreign tax credit without regard to the requirement that more than 50 percent of the value of its total assets consist of stock or securities in foreign corporations.

For this purpose, a qualified fund of funds means 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.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

D. Modification of Rules for Spillover Dividends of RICs (sec. 304 of the bill and sec. 855 of the Code)

Present Law

A RIC may elect to have certain dividends paid after the close of a taxable year considered as having been paid during that year for purposes of the RIC distribution requirements and determining the taxable income of the RIC.[44] These dividends are referred to as "spillover dividends." In order to qualify as a spillover dividend, the dividend must be declared prior to the time prescribed for filing the tax return for the taxable year (determined with regard to extensions) and the distribution must be made in the 12-month period following the close of the taxable year and not later than the date of the first dividend payment made after the declaration.

Explanation of Provision

The time for declaring a spillover dividend is the later of the 15th day of the 9th month following the close of the taxable year or the extended due date for filing the return. Also, the requirement that the distribution be made not later than the date of the first dividend payment after the declaration is changed. The provision provides that the distribution 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. For this purpose, a dividend attributable to short-term capital gain with respect to which a notice is required under the Investment Company Act of 1940 shall be treated as the same type of dividend as a capital gain dividend.[45]

Effective Date

The provision applies to distributions in taxable years beginning after the date of enactment.

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[44] Sec. 855.

[45] See section 19 of the Investment Company Act of 1940, as amended, for rules requiring notice to shareholders identifying source of distribution.

E. Return of Capital Distributions of RICs (sec. 305 of the bill and sec. 316 of the Code)

Present Law

A dividend is a distribution of property by a corporation (1) out of its earnings and profits accumulated after February 28, 1913 ("accumulated earnings and profits"), and (2) out of its earnings and profits of the taxable year ("current earnings and profits").[46] The current earnings and profits are prorated among current year distributions.[47] Distributions of property which are not a dividend reduce the adjusted basis of a shareholder's stock and are treated as gain to the extent in excess of the stock's adjusted basis.[48]

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

Explanation of Provision

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

Thus, under the provision, in the above example, all $3 million of the distribution made on September 15 is out of current earnings and profits and thus treated as dividend income. Only $1 million of the distribution made on March 15 is out of current earnings and profits and treated as dividend income. The remaining $2 million of the March 15 distribution is applied against the adjusted basis of each shareholder's stock or taken into account as gain by the shareholders.

In the case of a RIC with more than one class of stock, the provision applies separately to each class of stock.[49]

Effective Date

The provision applies to distributions made in taxable years beginning after the date of enactment.

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[46] Sec. 316.

[47] Treas. Reg. sec. 1.316-2(b).

[48] Sec. 301(c).

[49] See Rev. Rul. 69-440.

F. Distributions in Redemption of Stock of RICs (sec. 306 of the bill and secs. 267 and 302 of the Code)

Present Law

Exchange treatment

The redemption of stock by a corporation is treated as an exchange of stock if the redemption fits into one of four categories of transactions.[50] If the redemption does not fit into one of these categories, the redemption is treated as a distribution of property. One of the four categories of transactions is that the redemption "is not essentially equivalent to a dividend."[51] A redemption "is not essentially equivalent to a dividend" if the redemption results in a "meaningful reduction in the shareholder's proportionate ownership in the corporation."[52] Other categories include a substantially disproportionate redemption, a redemption that terminates the shareholder's interest in the corporation, and a partial liquidation (if the redeemed shareholder is not a corporation).[53]

The Code provides no specific rule regarding the application of the "not essentially equivalent to a dividend" test in the case of an open-end RIC whose shareholders "sell" their shares by having them redeemed by the issuing RIC and where multiple redemptions by different shareholders may occur daily.

Loss deferral

Any deduction in respect of a loss from the sale or exchange of property between members of a controlled group of corporation is deferred until the transfer of the property outside the group.[54] In the case of a fund of funds, a lower-tier fund may be required to redeem shares in an upper-tier fund when the upper-tier fund shareholders demand redemption of their shares. Because the upper-tier fund and lower-tier fund may be members of the same controlled group of corporations, any loss by the upper-tier fund on the disposition of the lower-tier fund shares may be deferred.

[50] Sec. 302.

[51] Sec. 302(b)(1).

[52] *United States v. Davis*, 397 U.S. 301 (1970).

[53] Sec. 302(b)(2)-(4).

[54] Sec. 267(f).

Explanation of Provision

Exchange treatment

The bill provides that, except to the extent provided in regulations, the redemption of stock of a publicly offered RIC is treated as an 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. A publicly offered RIC is a RIC the shares of which 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.

Loss disallowance

The bill provides that, except to the extent provided in regulations, the loss deferral rule does not apply to any redemption of stock of a RIC if the RIC issues only stock which is redeemable upon the demand of the shareholder and the redemption is upon the demand of a shareholder which is another RIC.

Effective Date

The provision applies to distributions after the date of enactment.

G. Repeal of Preferential Dividend Rule for Publicly Offered RICs (sec. 307 of the bill and sec. 562 of the Code)

Present Law

RICs are allowed a deduction for dividends paid to their shareholders. In order to qualify for the deduction, a dividend must not be a "preferential dividend."[55] For this purpose, a dividend is preferential unless it is distributed pro rata to shareholders, with no preference to any share of stock compared with other shares of the same class, and with no preference to one class as compared with another except to the extent the class is entitled to a preference. A distribution by a RIC to a shareholder whose initial investment was $10 million or more is not treated as preferential if the distribution is increased to reflect reduced administrative cost of the RIC with respect to the shareholder.

Securities law, administered by the Securities Exchange Commission, provides strict limits on the ability of RICs to issue shares with preferences.[56]

Explanation of Provision

The provision 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.

Effective Date

The provision applies to distributions in taxable years beginning after the date of enactment.

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[55] Sec. 562(c).

[56] See, for example, section 18 of the Investment Company Act of 1940.

H. Elective Deferral of Certain Late-Year Losses of RICs (sec. 308 of the bill and sec. 852(b)(8) of the Code)

Present Law

Capital gains and losses

In general

In general, a RIC may pay a capital gain dividend to its shareholders to the extent of the RIC's net capital gain for the taxable year. The shareholders treat capital gain dividends as long-term capital gain.[57]

Under present law, an excise tax is imposed on a RIC for a calendar year equal to four percent of the excess (if any) of the required distribution over the distributed amount. The required distribution is the sum of 98 percent of the RIC's ordinary income for the calendar year and 98 percent of the capital gain net income for the one-year period ending October 31 of such calendar year. The distributed amount is the sum of the deduction for dividends paid during the calendar year and the amount on which a corporate income tax is imposed on the RIC for taxable years ending during the calendar year.[58]

Deferral of net capital losses and long-term capital losses

Under present law, for purposes of determining the amount of a net capital gain dividend, the amount of net capital gain for a taxable year is determined without regard to any net capital loss or net long-term capital loss attributable to transactions after October 31 of the taxable year, and the post-October net capital loss or net long term capital loss is treated as arising on the first day of the RIC's next taxable year.[59]

Present law provides that to the extent provided in regulations, the above rules relating to post-October net capital losses also apply for purposes of computing taxable income of a RIC.[60] Regulations have been issued allowing RICs to elect to defer all or part of any net capital loss (or if there is no such net capital loss, any net long-term capital loss) attributable to the portion of the taxable year after October 31 to the first day of the succeeding taxable year.[61]

The following example illustrates the application of the post-October capital loss rules.

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[57] See explanation of section 301 of the bill.

[58] Sec. 4982.

[59] Section 852(b)(3)(C). Certain RICs with taxable years ending with the month of November or December are not subject to this rule.

[60] The last sentence of Sec. 852(b)(3)(C).

[61] Treas. Reg. 1.852-11.

Assume a RIC with a taxable year ending June 30, 2011, recognizes a long-term capital gain of $1,000,000 on September 15, 2010. In order to avoid the excise tax, the RIC distributes $980,000 on December 15, 2010, which it designates as a capital gain dividend. On January 15, 2011, the RIC recognizes a $600,000 long-term capital loss. The RIC has no other income or loss during 2010 and 2011, and has no accumulated earnings and profits.

Absent the post-October loss rule, the RIC would have a net capital gain (and current earnings and profits) of only $400,000 for the taxable year ending June 30, 2011. Only $400,000 of the December 15, 2010, distribution would be a capital gain dividend; the remaining $580,000 of the $980,000 distributed on December 15 would be a return of capital. Because the "distributed amount" for excise tax purposes takes into account only those distributions for which a dividend paid deduction is allowed, the RIC's distributed amount for calendar year 2010 would be $400,000, which is less than the distributed amount required to avoid the excise tax. In addition, the shareholders may have improperly reported the distribution as a capital gain dividend on the 2010 income tax returns.

By "pushing" the post-October long-term capital loss to July 1, 2011, in the above example the entire $980,000 paid on December 15, 2010, is a capital gain dividend. The distribution is fully deductible in computing the excise tax. No excise tax is imposed for 2010 because the RIC has no undistributed income.

Short-term capital losses not deferred

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

The following example illustrates the present-law treatment of a RIC with a post-October 31 short-term capital loss:

Assume a RIC with a taxable year ending June 30, 2011, recognizes a short-term capital gain of $1 million on September 15, 2010. In order to avoid the excise tax, the RIC distributes $980,000 on December 15, 2010. On May 15, 2011, the RIC recognizes a $1 million long-term capital gain and $1 million short term-capital loss. The RIC has no other income or loss during 2010, 2011, or 2012 (and has no accumulated earnings and profits).

Under present law, the shareholders receive Forms 1099 for 2010 reporting the dividends as other than capital gain dividends and they report the dividends accordingly on their 2010 income tax returns. Because the RIC has only $1 million of current earnings and profits for its taxable year, the RIC may not pay an additional distribution designated as a capital gain dividend for its taxable year in order to be allowed a dividend paid deduction in computing the RIC's tax on net capital gain. Instead, the RIC could designate the December 15 distribution as a capital gain dividend, but that would require shareholders to file amended income tax returns for 2010.

Deferral partly elective

Under present law, for purposes of determining capital gain dividends, the "push" forward of post-October capital losses is automatic, rather than elective; in contrast the push forward of these losses is elective for RIC taxable income purposes. Assume for example that a

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

Ordinary gains and losses

Net foreign currency losses and losses on stock in a passive foreign investment company

In applying the excise tax described above, net foreign currency losses and gains and ordinary loss or gain from the disposition of stock in a passive foreign investment company ("PFIC") properly taken into account after October 31 are "pushed" to the following calendar year for purposes of the tax.[62]

Under present law, to the extent provided in regulations, a RIC may elect to push the post-October net foreign currency losses and the net reduction in the value of stock in a PFIC with respect to which an election is in effect under section 1296(k) forward to the next taxable year.[63] Regulations have been issued allowing RICs to elect to defer all or part of any post-October net foreign currency losses for the portion of the taxable year after October 31 to the first day of the succeeding taxable year.[64]

Other ordinary losses

Other ordinary losses of a RIC may not be "pushed" forward. As a result, in the event that a RIC has net ordinary losses for the portion of the taxable year after December 31 (other than a net foreign currency loss or loss on stock of a PFIC), the RIC may have insufficient earnings and profits to pay a dividend during the calendar year ending in the taxable year in order to reduce or eliminate the excise tax.

For example, assume a RIC for its taxable year ending June 30, 2012, has ordinary income of $1 million for the portion of its taxable year ending on December 31, 2011. In order to avoid the excise tax, the RIC distributes $980,000 on December 15, 2011. The RIC has no

[62] Sec. 4982(e)(5) and (6).

[63] Sec. 852(b)(8) and (10).

[64] Treas. Reg. 1.852-11.

accumulated earnings and profits. For the period beginning January 1, 2012, and ending on June 30, 2012, the RIC has a net ordinary loss of $1 million. Because the RIC has no earnings and profits, the distribution in 2011 is not a dividend; the distributed amount for calendar year 2011 is zero; and an excise tax is imposed.

Explanation of Provision

Post- October capital losses

Under the provision, except to the extent provided in regulations, a RIC may elect to "push" to the first day of the next taxable year part or all of any post-October capital loss. The post-October capital loss means the greatest of the RIC's net capital loss, net long-term capital loss, or the net short-term capital loss (attributable to the portion of the taxable year after October 31).[65]

The election[66] applies for all purposes of the Code, including determining taxable income, net capital gain, net short-term capital gain, and earnings and profits.

The application of the provision to short-term capital losses may be illustrated by the following example:

Assume a RIC for its taxable year ending June 30, 2012, recognizes a short-term capital gain of $1 million on September 15, 2011. In order to avoid the excise tax, the RIC distributes $980,000 on December 15, 2011. On May 15, 2012, the RIC recognizes a $1 million long-term capital gain and $1 million short term-capital loss. The RIC has no other income or loss during 2011, 2012, or 2013 (and has no accumulated earnings and profits).

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

Late-year ordinary losses

Under the provision, except to the extent provided in regulations, a RIC may elect to "push" to the first day of the next taxable year part or all of any qualified late-year ordinary loss. The qualified late year ordinary loss is the excess of (1) the sum of the specified losses attributable to the portion of the taxable year after October 31 and other ordinary losses attributable to the portion of the taxable year after December 31, over (2) the sum of the specified gains attributable to the portion of the taxable year after October 31 and other ordinary

[65] Special rules apply to certain RICs with taxable years ending with the month of November or December.

[66] The principles of Treasury Regulation 1.852-11 are to apply to a qualified late-year loss for which an election is made under this provision, subject to any subsequent change in the regulations.

income attributable to the portion of the taxable year after December 31. Specified losses and gains have the same meaning as used for purposes of the excise tax under section 4982.[67]

The election applies for all purposes of the Code.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

[67] See explanation of section 402 of the bill.

I. Exception to Holding Period Requirement for Exempt-Interest Dividends Declared on Daily Basis (sec. 309 of the bill and sec. 852(b)(4) of the Code)

Present Law

If a shareholder receives an exempt-interest dividend with respect to a share of RIC stock held for 6 months or less, any loss on the sale or exchange of the stock, to the extent of the amount of the exempt-interest dividend, is disallowed. To the extent provided by regulations, the loss disallowance rule does not apply to losses on shares which are sold or exchanged pursuant to a plan which involves the periodic liquidation of the shares. In the case of a RIC which regularly distributes at least 90 percent of its net tax-exempt interest, the Secretary may by regulations prescribe a shorter holding period not shorter than the greater of 31 days or the period between the regular distributions.

Explanation of Provision

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

Effective Date

The provision applies to stock for which the taxpayer's holding period begins after the date of enactment of this provision.

V. MODIFICATIONS RELATED TO EXCISE TAX APPLICABLE TO RICS

A. Excise Tax Exemption for Certain RICs Owned by Tax Exempt Entities (sec. 401 of the bill and sec. 4982(f) of the Code)

Present Law

An excise tax is imposed on a RIC for a calendar year equal to four percent of the excess (if any) of the required distribution over the distributed amount. The required distribution is the sum of 98 percent of the RIC's ordinary income for the calendar year and 98 percent of the capital gain net income for the one-year period ending October 31 of such calendar year. The distributed amount is the sum of the deduction for dividends paid during the calendar year and the amount on which a corporate income tax is imposed on the RIC for taxable years ending during the calendar year.[68]

The excise tax does not apply to a RIC for any calendar year 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.

Explanation of Provision

The provision adds tax-exempt entities whose ownership of beneficial interests in the RIC would not preclude the application of section 817(h)(4) (regarding segregated asset accounts of a variable annuity or life insurance contract) to the list of persons who may hold stock in a RIC that is exempt from the excise tax. 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).[69] Also, another RIC to which section 4982 does not apply may hold stock in a RIC exempt from the excise tax.

Effective Date

The provision applies to calendar years beginning after the date of enactment.

[68] Sec. 4982.

[69] See Rev. Rul. 94-62, 1994-2 C.B. 164, as supplemented by Rev. Rul. 2007-58, I.R.B. 2007-37 (Sept. 10, 2007).

B. Deferral of Certain Gains and Losses of RICs for Excise Tax Purposes (sec. 402 of the bill and sec. 4982(e) of the Code)

Present Law

Special rules apply to certain items of income and loss in computing the excise tax under section 4982.[70] Any foreign currency gains and losses attributable to a section 988 transaction properly taken into account after October 31 of any calendar year generally are "pushed" to the following calendar year.[71] Any post-October positive or negative adjustments, and income or loss, on contingent payment debt instruments is treated in the same manner as foreign currency gain or loss from a section 988 transaction.[72] Any gain recognized under section 1296 (relating to mark-to-market for marketable stock in a passive foreign investment company ("PFIC")) generally is determined as if the RIC's taxable year ends October 31, and any gain or loss from an actual disposition of stock in an electing PFIC after October 31 generally is "pushed" to the following calendar year.[73]

To the extent provided in regulations, any net foreign currency loss of a RIC and any net reduction in the value of the stock of a PFIC held by a RIC attributable to transactions after October 31 of the taxable year may be "pushed" to the first day of the following taxable year for purposes of computing taxable income.[74] Similar rules apply for purposes of computing earnings and profits in order to allow a RIC a distribution deduction for purposes of the excise tax.[75]

Explanation of Provision

Under the provision, the present-law excise tax "push" rules applicable to foreign currency gains and losses are expanded to include all "specified gains and losses," i.e., ordinary gains and losses from the sale, exchange, or other disposition of (or termination of a position with respect to) property, including foreign currency gain and loss, and amounts marked-to-market under section 1296. Thus, these post-October 31 gains and losses are "pushed" to the next calendar year.[76]

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[70] See section 401 for a description of the tax.

[71] Sec. 4982(e)(5).

[72] See Treas. Reg. 1.1275-4(b)(9)(v).

[73] Sec. 4982(e)(6).

[74] Sec 852(b)(8) and (10). See Treas. Reg. 1.852-11 for rules relating to the treatment of losses attributable to periods after October 31 of a taxable year.

[75] Sec. 852(c)(2).

[76] For treatment of these losses for income tax purposes, see section 852(b)(8) of the Code, as amended by section 308 of the bill.

The provision also provides that, for purposes of determining a RIC's ordinary income, the present-law rule treating PFIC stock as disposed of on October 31 is made applicable to all property held by a RIC which under any provision of the Code (including regulations thereunder) is treated as disposed of on the last day of the taxable year.

Finally, for purposes of the excise tax, the provision allows a taxable year RIC, except as provided in regulations, to elect to "push" any net ordinary loss (determined without regard to ordinary gains and losses which are automatically "pushed" to the next calendar year) attributable to the portion of the calendar year after the beginning of the taxable year which begins in the calendar year to the first day of the next calendar year.

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

Effective Date

The provision applies to calendar years beginning after the date of enactment.

C. Distributed Amount for Excise Tax Purposes Determined on Basis of Taxes Paid by RIC (sec. 403 of the bill and sec. 4982(c)(4) of the Code)

Present Law

In computing the excise tax under section 4982,[77] a RIC is treated as having distributed amounts on which a tax is imposed on the RIC during the calendar year in which the taxable year of the RIC ends, regardless of the calendar year in which estimated tax payments are made.[78]

Explanation of Provision

Under the provision, a RIC making estimated tax payments of the taxes imposed on investment company taxable income and undistributed net capital gain for a taxable year beginning (but not ending) during any calendar year may elect to increase the distributed amount for that calendar year by the amount on which the estimated tax payments of these taxes are made during that calendar year. The distributed amount for the following calendar year is reduced by the amount of the prior year's increase.

Effective Date

The provision applies to calendar years beginning after the date of enactment.

[77] See section 401 for a description of the tax.

[78] Sec. 4982(c)(1)(B).

D. Increase in Required Distribution of Capital Gain Net Income (sec. 404 of the bill and sec. 4982 of the Code)

Present Law

An excise tax is imposed on a RIC for a calendar year equal to four percent of the excess (if any) of the required distribution over the distributed amount. The required distribution is the sum of 98 percent of the RIC's ordinary income for the calendar year and 98 percent of the capital gain net income for the one-year period ending October 31 of such calendar year. The distributed amount is the sum of the deduction for dividends paid during the calendar year and the amount on which a corporate income tax is imposed on the RIC for taxable years ending during the calendar year.[79]

Explanation of Provision

The provision increases the required distribution percentage of the capital gain net income from 98 percent to 98.2 percent

Effective Date

The provision applies to calendar years beginning after the date of enactment.

[79] Sec. 4982.

VI. OTHER PROVISIONS

A. Repeal of Assessable Penalty with Respect to Liability for Tax of RICs (sec. 501 of the bill and sec. 6697 of the Code)

Present Law

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."[80] A deficiency dividend is treated by the RIC as a dividend paid with respect to the prior taxable year. As a result, the deficiency dividend increases the RIC's deduction for dividends paid for that year and eliminates the deficiency. A RIC making a deficiency dividend is subject to an interest charge as if the entire amount of the deficiency dividend were the amount of the tax deficiency. An additional penalty is also imposed equal to the lesser of (1) the amount of the interest charge, or (2) one-half of the amount of the deficiency dividend.[81]

Explanation of Provision

The provision repeals the additional penalty with respect to deficiency dividends.

Effective Date

The provision applies to taxable years beginning after the date of enactment.

[80] Sec. 860.

[81] Sec. 6697.

B. Modification of Sale Load Basis Deferral Rule for RICs (sec. 502 of the bill and sec. 852(f)(1) of the Code)

Present Law

If (1) a taxpayer incurs a load charge in acquiring stock in a RIC and by reason of incurring the charge or making the acquisition, acquires a reinvestment right, (2) the stock is disposed of within 90 days of the acquisition, and (3) the taxpayer subsequently acquires stock in a RIC and the otherwise applicable load charge is reduced by reason of the reinvestment right, the load charge (to the extent it does not exceed the reduction) is not taken into account in determining gain or loss of the original stock but is treated as incurred in acquiring the subsequently acquired stock.[82]

Explanation of Provision

The provision limits the applicability of the provision described under present law to cases where the taxpayer subsequently acquires stock before January 31 of the calendar year following the calendar year the original stock is disposed of.

Effective Date

The provision applies to charges incurred in taxable years beginning after the date of enactment.

[82] Sec. 852(f).