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By Electronic Delivery

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Emily S. McMahon
Deputy Assistant Secretary for Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Guidance Priority List Recommendations

Dear Ms. McMahon and Mr. Wilkins:

The Investment Company Institute¹ recommends the following issues affecting regulated investment companies (“RICs”) and their shareholders for inclusion on the 2011-2012 Guidance Priority List.² As requested in Notice 2011-39, these recommendations have been listed in order of priority. The Institute notes, however, that all of the issues described below are important to the industry; most of these items have been included in prior requests for guidance from the Internal Revenue Service (“IRS”) and the Treasury Department, including prior suggestions for the Guidance Priority List.

I. Items Related to RIC Modernization Act of 2010

The Regulated Investment Company Modernization Act of 2010 (“the Act”)³ resolved several issues for which we previously sought regulatory guidance. We request guidance clarifying three of the Act’s provisions. The Institute will submit soon a detailed proposal regarding each of these three issues.

First, we request guidance clarifying the effective date, for section 4982 excise tax purposes, of the Act’s changes to the section 1212 capital loss carryover provisions.⁴ While the Act’s effective date – net capital losses for taxable years beginning after December 22, 2010 – is applied easily for income tax purposes (based upon the RIC’s taxable year), application is more difficult for section 4982 purposes.

¹ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.1 trillion and serve over 90 million shareholders.

² A separate submission describes our Guidance Priority List recommendations for retirement security issues.

³ Pub. L. No. 111-325, 124 Stat. 3537.

⁴ *Id.* §101.

Specifically, while section 4982 requires that the RIC's distribution requirements be satisfied during the calendar year, the amounts subject to distribution are based upon either a November 1 – October 31 period (for capital gain net income) or a January 1 – December 31 period (for ordinary income).⁵ The Institute will propose that the Act's changes to section 1212 apply to a RIC's excise tax distribution requirements for calendar year 2011; under this proposal, the measurement of capital gains and losses to which the new capital loss carryover provisions will apply would begin on November 1, 2010.

Second, we request guidance clarifying that the so-called bifurcation guidance of Notice 97-64⁶ (as modified by Notice 2004-39⁷) continues to apply, to the extent necessary, after the Act's changes to the elective deferral rules for post-October losses. Specifically, a RIC still needs to "bifurcate" its taxable year into two components (to prevent character reclassifications), when a RIC (i) has a pre-November net capital gain, (ii) has a post-October loss in a long-term category (i.e., 15% or 28%) that could change the category of the pre-November net capital gain on a taxable year basis, and (iii) does not have a post-October net capital loss, net long-term loss or net short-term loss that, if deferred, would avoid the reclassification.

Third, we request guidance allowing a RIC to meet the Act's requirement to provide its shareholders with a "written statement" regarding the character of its distributions by posting the information on its website and advising its shareholders, in writing, to consult the website for this information.⁸

II. 2011-2012 Guidance Priority List Items

The Institute requests that the IRS and Treasury Department issue guidance as soon as possible on the following items currently on the 2010-2011 Guidance Priority List.

A. Distressed Debt

First, the Institute requests guidance addressing the accrual of interest on distressed debt. Investors have long faced uncertainty regarding how the existing original issue discount and market discount rules should apply to severely distressed, and speculative, debt. In other cases, application of

⁵ I.R.C. §4982(b)(1)(B).

⁶ 1997-2 C.B. 323.

⁷ 2004-1 C.B. 982.

⁸ Regulated Investment Company Modernization Act of 2010, Pub. L. No. 111-325, §301.

these rules creates what many believe to be inappropriate results.⁹ These issues have been exacerbated by recent market events.¹⁰

B. Notional Principal Contracts

Second, the Institute remains very interested in guidance providing simplicity and certainty regarding the taxation of notional principal contracts. In our letter on the regulations proposed in 2004,¹¹ we expressed reservations about the proposed regulations' complexity and recommended significant modifications. We recommended that marks under the elective mark-to-market method, as well as value payments under the noncontingent swap method, be treated as resulting in capital gain or loss. We also suggested that credit default swaps and certain short-term swaps be excluded from the modified noncontingent swap method and the mark-to-market election. We requested additional guidance on determining whether a payment is "significant." We also commented on several technical issues. Finally, we suggested that the guidance should be made entirely prospective upon promulgation of final regulations.

C. Prepaid Forward Contracts

Third, we urge guidance on prepaid forward contracts.¹² Specifically, the Institute strongly supports prompt and comprehensive guidance regarding the tax treatment of exchange-traded notes ("ETNs"). While ETNs can provide important investment opportunities, they also take advantage of gaps in the tax law to provide investors with tax deferral (of up to 30 years) and character conversion that is inappropriate. This treatment is far more favorable than the treatment obtained by investors in comparable financial instruments and provides a tax incentive to take on issuer credit risk (rather than invest in products that do not entail this risk). In the absence of legislation, regulations should be issued under Treasury's existing authority under section 1260 and should provide a mark-to-market election. If a comprehensive regulatory approach is not developed under section 1260, guidance should be issued under section 446 to address any ETNs that remain outside the scope of the section 1260 constructive ownership solution.

D. Section 1256 Contracts

⁹ See, e.g., Letter of May 15, 1991, from Jere D. McGaffey to Fred T. Goldberg, Jr. (transmitting comments prepared by members of the ABA's Section of Taxation on the application of market discount rules to speculative bonds).

¹⁰ See, e.g., Institute letter to Eric Solomon and Donald Korb, dated July 28, 2008.

¹¹ See Institute letter to Greg F. Jenner and Donald L. Korb, dated July 21, 2004.

¹² See Institute letter to Eric Solomon and Donald L. Korb, dated May 13, 2008. See also, Testimony of William M. Paul on behalf of the Institute, presented on March 5, 2008 before the House Ways and Means Subcommittee on Select Revenue Measures. <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=6824>.

Finally, the Institute requests guidance regarding section 1256's application to certain derivative contracts. The Dodd-Frank Act¹³ amended section 1256 to exclude from its purview nine specific derivative contracts and "any similar agreement."¹⁴ The legislative history suggests that the amendment was intended to "clarify" the application of section 1256.¹⁵ Considerable concern remains, however, that economically comparable financial instruments which were considered "section 1256 contracts" prior to Dodd-Frank may no longer be considered "section 1256 contracts."¹⁶ Guidance, that applies on a prospective basis only, should be issued to clarify more precisely which derivative contracts constitute "section 1256 contracts" following the amendment of section 1256(b).

III. Other Issues Directly Affecting RICs and Their Shareholders

A. The Application of General Corporate Tax Rules to RICs

The Institute requests that the IRS and Treasury address issues arising from the application of the general corporate tax rules to RICs. These rules can be unnecessarily difficult to apply and can result in unintended consequences.

1. Business Continuity Requirement for Tax-Free Mergers

First, the Institute requests guidance clarifying the application of the "business continuity" requirement to RICs under section 368 and Treas. Reg. § 1.368-1(d)(2).¹⁷ This clarification is necessary because it is difficult to discern the intended scope of the business continuity test as applied to RIC reorganizations. As a result, many RICs engaging in merger transactions are compelled to rely on the "asset continuity" test;¹⁸ this test, to the detriment of the RIC's shareholders, can place artificial limits on the ability of a portfolio manager to dispose of portfolio securities acquired from a target RIC and imposes significant compliance burdens on funds. This issue has become increasingly important given recent financial conditions, under which more and more RICs are being merged. The Institute requested guidance on this issue in 2004, at which point the IRS informed us that they wished to gather more information on RIC mergers through the private letter ruling process. The Institute hopes that

¹³ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203.

¹⁴ *Id.* §1601.

¹⁵ H.R. Rep. No. 111-517, at 879 (2010)(Conf. Rep.).

¹⁶ See Erika W. Nijenhuis, New Tax Issues Arising From the Dodd-Frank Act and Related Changes to Market Practice for Derivatives, 2 Colum. J. Tax L. 1 (2011).

¹⁷ See Institute letter to William D. Alexander and Lon B. Smith, dated January 15, 2003. See also Institute letter to William D. Alexander, dated April 30, 2004.

¹⁸ See Treas. Reg. § 1.368-1(d)(3).

the IRS and Treasury now have sufficient information to open a project on this issue and requests that they do so.

2. Ownership Tracking Requirements

Second, the Institute asks that a project be opened to amend the regulations under sections 382 and 383 with respect to ownership tracking requirements that apply to participant-directed retirement accounts holding RIC shares and to variable insurance products. Specifically, the regulations should permit a RIC to look through participant-directed retirement accounts and variable insurance product account owners and treat each participant/investor who holds less than five percent of the RIC's shares as part of the RIC's direct public group. The concerns against which sections 382 and 383 are directed are not implicated when a RIC's new shareholders are retirement accounts or variable insurance product accounts that cannot benefit from such tax attributes.

This change effectively would prevent a large collection of small investors making independent investment decisions from being treated as a single entity for ownership change purposes. Absent this change, a retirement plan administrator's decision as to what RICs to offer in a plan could significantly affect whether other shareholders in the RIC can benefit from the RIC's capital losses even though the retirement plan administrator is neither a beneficial owner of RIC shares nor responsible for allocating investment assets among RICs. Likewise, absent this change, an ownership change could occur if another company buys the insurance company holding the variable insurance product shares.

B. RIC Portfolio Investments

The Institute requests guidance on several issues arising from RICs' portfolio investments.

1. PFICs

First, we ask the IRS and Treasury to issue additional guidance regarding passive foreign investment companies ("PFICs"). The preamble to the final PFIC mark-to-market regulations (TD 9123) published on April 29, 2004, notes in three places that comments received relating to the impact of the PFIC rules on RICs were beyond the scope of that regulations project.¹⁹ We request that a regulations project be opened to address these and other PFIC-related issues faced by the industry.

Specifically, the Institute requests guidance providing (i) that gains from dispositions of former PFIC stock are capital while losses are ordinary to the extent of prior unreversed inclusions; (ii) RICs with automatic consent to terminate a section 1296 election during a non-PFIC year; (iii) that RICs may recognize any change in PFIC status of a foreign corporation for the RIC's taxable year within which the taxable year of the foreign corporation ends; (iv) that the consequences to RICs of applying former Prop. Treas. Reg. § 1.1291-8 will be respected, where relevant, for purposes of section 1296; and

¹⁹ See Institute letter, dated November 22, 2002, and Institute letter to Dale S. Collinson, dated April 24, 2003.

(v) that RICs may determine qualified electing fund (“QEF”) inclusions using audited financial statements that were prepared using U.S. Generally Accepted Accounting Principles or International Financial Reporting standards, and that all QEF inclusions subject to this election will be treated as ordinary, but retain the capital character of disposition gains and losses.

2. RIC Investments in Partnerships with Different Taxable Year-Ends

Second, we request guidance regarding RIC investments in a partnership in which the RICs and the partnership have different tax years; this guidance should allow RICs to take partnership items into income at the end of each month, rather than at year-end. In general, partners must take partnership items into account at the end of the partnership’s tax year.²⁰ If a RIC invests in a partnership with a different tax year, however, this can cause mismatches between the RIC’s distributions and the amount of earnings and profits associated with the partnership’s income.

3. Taxable Mortgage Pools

Third, we request regulatory guidance to clarify issues relating to excess inclusion income of a REIT that is a taxable mortgage pool (“TMP”) or that has a qualified REIT subsidiary that is a TMP. While Notice 2006-97²¹ addressed a few issues, and responded to some of the Institute’s concerns with the lack of guidance in this area,²² many critically important issues remain unresolved. At a minimum, and as requested by the Institute in 2006, guidance should be issued stating that Notice 2006-97 will not be applied until some reasonable period after a practical reporting regime is implemented and the many uncertainties arising from the Notice are resolved.²³

C. Check-The-Box Election

The Institute urges the IRS and Treasury Department to issue guidance to coordinate the entity classification election under the check-the-box regulations²⁴ with the RIC election under section 851(b)(1). We anticipate filing a submission soon that will request guidance providing RICs with the same rule already applicable to REITs.²⁵ Specifically, we will request that an eligible entity that makes a

²⁰ See Rev. Rul. 94-40, 1994-1 C.B. 274 (for purposes of the required distribution under §4982, a RIC must take into account its share of partnership items of income, gain, loss, and deduction as they are taken into account by the partnership, regardless of the taxable years of the RIC and the partnership in which the RIC is a partner).

²¹ 2006-2 C.B. 904.

²² See Institute letter to Eric Solomon and Donald L. Korb, dated May 12, 2006.

²³ See Institute letter to Lon B. Smith, dated December 29, 2006.

²⁴ Treas. Regs. §301.7701-3.

²⁵ See Treas. Regs. §301.7701-3(c)(1)(v)(B).

timely RIC election on its first tax return²⁶ will be treated as having made a check-the-box election, effective as of the first day the entity is treated as a RIC.

D. Information Reporting

The Institute also asks the IRS and Treasury Department to issue guidance on several important reporting issues affecting RICs and their shareholders.

1. Uncertain Tax Positions

The Institute urges the IRS to exempt from Schedule UTP reporting those tax positions for which a FIN 48 liability is not recorded because of administrative practice.

2. TIN Masking

Second, the Institute asks the IRS and Treasury Department to make permanent its pilot program (recently extended for two more years)²⁷ permitting information return filers to “mask” (or obscure) the full Social Security number on Forms 1099 and 5498 mailed to investors, with the changes suggested by the Institute.²⁸ Masking or obscuring the full taxpayer identification number is the most effective way to combat identity theft, and many RICs already do so on non-tax documents sent to shareholders. The pilot program has been an important step towards minimizing situations in which taxpayers’ personal information may be misappropriated from tax forms.

IV. Section 529 Qualified Tuition Programs

The ICI also urges the IRS and Treasury to address issues regarding section 529 qualified tuition programs (“section 529 plans”). A project to address these issues, which was included on prior Guidance Priority Lists, similarly was deleted from the 2009-2010 list without guidance being issued. Guidance regarding section 529 plans remains necessary to implement fully the Advance Notice of Proposed Rulemaking (“Advance Notice”) regarding section 529 plans that the IRS released in 2008. We are pleased that the Advance Notice reflects several comments previously submitted jointly by the Institute and the Securities Industry and Financial Markets Association (“SIFMA”).²⁹ It remains important, for those saving for education through section 529 plans, that the tax treatment of

²⁶ Treas. Reg. §1.851-2(a).

²⁷ See Notice 2011-38, 2011-20 I.R.B. 785.

²⁸ See Institute letter regarding Notice 2009-93, dated April 30, 2010.

²⁹ See Institute and SIFMA letter to Michael Desmond, dated June 12, 2007.

investments in such plans be clear. We urge the IRS to continue its work on this guidance project to address outstanding issues.³⁰

V. Foreign Bank and Financial Account Reporting

Finally, we are very pleased that the IRS and Treasury Department have finalized rules regarding the reporting of foreign financial accounts on the Report of Foreign Bank and Financial Accounts, Form TD-F 90-22.1.³¹ We ask that you clarify and expand upon the final rules in certain limited ways. Specifically, we request clarification that (1) a so-called “segregated account” in a foreign country that is created by a U.S. global custodian for the benefit of an investment company is not a foreign financial account of the investment company so long as the investment company cannot access directly the foreign account; (2) officers of investment companies may utilize the signature authority exception for officers of financial institutions; and (3) an officer or employee of a U.S. parent company that is either a financial institution or publicly traded has no FBAR reporting obligation for any foreign account of a domestic or foreign subsidiary of the parent for which the individual has signature authority (so long as he or she has no financial interest in the account).

We also request guidance on three additional points. First, we request that officers and employees of a subsidiary, the parent of which is a financial institution or publicly traded, receive the same signature authority exception provided to officers and employees of the parent with respect to *all* of the parent’s financial interests. Second, we request that the reporting exception for officers and employees of foreign subsidiaries (provided by the 2008 FBAR instructions) be restored. Third, we request that officers and employees of non-bank affiliates of banks that perform transfer agency and other administrative functions for their investment company clients, when the affiliate is registered with an “appropriate regulatory authority” and examined by its Federal functional regulator or the Securities and Exchange Commission, be eligible for the “authorized service provider” reporting exception.

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³⁰ See Institute letter to Richard Hurst, Mary Berman and Monice Rosenbaum, dated May 12, 2008, for comments regarding the Advance Notice.

³¹ See Institute letter to James H. Fries, dated May 23, 2011.

We will contact your offices shortly to request a meeting to discuss further these issues and their importance to the industry. In the meantime, if we can provide you with any additional information regarding these issues, please do not hesitate to contact Keith Lawson (at 202/326-5832 or lawson@ici.org) or me (at 202/326-5876 or pinank.desai@ici.org).

Sincerely,

/s/ Pinank Desai

Pinank Desai
Assistant Counsel – Tax Law

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