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RE: Proposed Guidance on Taxation of Money
Market Funds – Supplemental Information

Dear Mr. Novey and Mr. Harrison:

The Investment Company Institute¹ is pleased to provide additional information in response to questions raised at the public hearing on recently proposed regulations regarding the taxation of money market funds with floating net asset values (“NAVs”). Specifically, this letter addresses:

- Permitting use of the NAV method on an account-by-account basis;
- Aligning use of the NAV method by regulated investment companies (“RICs”) for income and excise tax purposes;
- Clarifying the definition of “fair market value” for purposes of the NAV method; and

¹ The Investment Company Institute (ICI) is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s U.S. fund members manage total assets of \$17.5 trillion and serve more than 90 million U.S. shareholders.

- Permitting existing money market funds with both retail and institutional investors to separate into two separate funds in a tax-free manner.

In addition to these points, the Institute plans to ask for additional guidance that was not requested in our original comment letter. It has come to our attention that some investment advisors are discussing the possibility of making payments to existing institutional money market funds to bring the NAV up to \$1.0000 before the compliance date for the final Securities and Exchange Commission (“SEC”) money market fund rule. The Institute plans to seek guidance regarding the proper tax treatment of such payments. Given the time sensitivity of the issues described above, however, the Institute plans to submit a separate letter in the near future regarding advisor contributions.

The Institute appreciates the efforts of the Treasury Department and the Internal Revenue Service (“IRS”) to issue final guidance on floating NAV money market funds in a timely manner. We hope that this supplemental information will be useful as the government works to finalize the guidance prior to implementation of the final SEC money market fund rule.

Application of the NAV Method on an Account-by-Account Basis

In our earlier comment letter,² we asked the Treasury Department and the IRS to permit money market fund shareholders to apply the NAV method on an account-by-account basis. We understand that some fund complexes and intermediaries are considering providing basis information to floating NAV money market fund shareholders on a voluntary basis. As we noted in our comment letter and our testimony, requiring a shareholder to use the NAV method for all floating NAV money market funds would preclude a shareholder who has used the NAV method for one account from reporting gains and losses using the cost basis information provided for another account. The purpose of the proposed NAV method was to simplify reporting for taxpayers who hold shares in institutional money market funds with floating NAVs. The NAV method, we believe, will advance this goal for floating NAV money market fund shareholders in most situations. In those circumstances, however, in which a fund or intermediary chooses to provide cost basis information to its customers, conventional tax accounting may be easier. Because the receipt of such information may further ease the investor’s tax reporting burdens, the Institute believes that shareholders should be permitted to use it, regardless of how it has accounted for shares in the same or other floating NAV money market fund. Permitting use of the NAV method on an account-by-account basis also would be consistent with the current application of cost basis methods under section 1012.

At the public hearing, the IRS asked whether it has the authority to permit use of the NAV method on an account-by-account basis, given that it is a method of accounting under section 446. There is support in the Internal Revenue Code, the Treasury regulations, and the case law for applying

² See Institute letter to Hon. Mark Mazur and Hon. William Wilkins, dated October 23, 2014.

different methods to two distinct items, notwithstanding any factual similarities.³ Such rationale should be applied to floating NAV money market funds. The most obvious reason is that different money market funds are separate and distinct from each other. They may have different investments, different advisors, different fees, and/or different investment objectives.⁴

An investor's accounts also should be treated as distinct items for which different methods of accounting are permitted even if they include shares in the same money market fund. As noted above, some fund complexes and/or intermediaries may choose to provide basis information, using one (but not all) of the methods permissible under section 1012, to their floating NAV money market fund shareholders. An investor who holds shares in a fund through more than one channel (*e.g.*, via a broker and in the fund directly) may receive information from each channel based on different methods or may not receive any information from one or more of the channels. To ease the administrative burden, the investor should be permitted to choose different accounting methods for each.

Further, given that many floating NAV money market fund investors will be large institutional clients, an investor could hold shares in the same money market fund through separate accounts across multiple business units. For example, the brokerage arm of the institution could use the money market fund as a sweep account, while the corporate treasurer could use the same fund for purposes of cash management. These two business purposes are separate and distinct, despite the use of the same money market fund. Because these accounts are used for different purposes, permitting the use of two different accounting methods is justified.⁵

Finally, many tax accounting systems treat each account as a separate entry, regardless of the shares held in each account. Requiring investors, many of which will be large institutions, to apply the NAV method across all (or no) money market fund accounts may be overly burdensome and costly.

We believe that the NAV method is a useful means for reporting gains and losses from floating NAV money market funds, and that it likely will reduce significantly taxpayers' reporting burdens. We also feel, however, that requiring money market fund investors to apply the NAV method across all accounts may create unnecessary complications. Given that each money market fund account is

³ See, *e.g.*, Prop. Treas. Reg. § 1.167(n)-1(b)(1) (permitting the taxpayer to choose between the income forecast method and another method with respect to each individual property, notwithstanding factual similarities among the properties); Treas. Reg. § 1.446-1(e)(2)(ii)(d)(4) (recognizing that generally each individual depreciable or amortizable asset constitutes a separate item with its own method of accounting); *Capital One Financial Corp. v. Commissioner*, 659 F. 3d 316, 320, 325-26 (4th Cir. 2011) (recognizing that various credit card fees were items distinct from credit card late fees); C.C.A. 200137026, at 3 (Jun. 14, 2001) ("If two identical items (for example, two forklifts) are primarily used in each of two separate industrial or commercial activities of a taxpayer, depreciation deductions for each item are based on the activity in which the item is primarily used.").

⁴ This alone suggests that the NAV method should be permitted at least on a fund-by-fund basis.

⁵ Various business units that keep complete and separable sets of books and records already are permitted to use different accounting methods for each unit, provided the method chosen clearly reflects the income of that particular trade or business. Treas. Reg. § 1.446-1(d)(1), (2); Rev. Proc. 2015-13, 2015-5 I.R.B. 419, Section 2.08(1).

separate and distinct, we believe the Treasury Department and the IRS have the authority to permit taxpayers to apply the NAV method on an account-by-account basis.

Applying the NAV Method for Excise Tax Purposes

In our initial comment letter and at the public hearing, the Institute asked the IRS and Treasury Department to confirm that, when a RIC invests in a floating NAV money market fund, the computation period for purposes of applying the NAV method to the section 4982 excise tax could be the one-year period ending on October 31. The government asked at the hearing for further insight as to how to ensure that application of the NAV method by RICs would align for income tax and excise tax purposes.

We understand that most RICs account for items that are marked to market under the Internal Revenue Code based on two different one-year periods for income tax and excise tax purposes. They determine their gain or loss on mark-to-market assets for income tax purposes based on the change in value of the asset over the fiscal year, and they determine their gain or loss for excise purposes based on the change in value over the period from 11/1 to 10/31. RICs that do not have a tax year ending October 31 thus generally keep two separate sets of books and records.⁶ The Institute's comment was focused on confirming that a RIC could apply the NAV method in the same manner.

Our initial concern was that this approach could be viewed as violating the NAV-method requirement that a computation period must not contain days from more than one taxable year, if a fund has a taxable year that does not end on October 31. We believe, however, that the better reading permits using an 11/1 - 10/31 computation period for excise tax purposes while using the RIC's taxable year as the computation period for income tax purposes. Section 4982(e)(2)(A) provides that capital gain net income has the same meaning as in section 1222(9) "determined by treating the one-year period ending on October 31 of any calendar year as the company's tax year." Thus, if a RIC chooses to use the one-year period ending on October 31 as its computation period for the NAV method for excise tax purposes, that computation period would contain days from only one taxable year for this purpose, thus satisfying the requirements in the proposed regulations. In other words, the one-year period ending on October 31 is presumed to be the RIC's tax year for purposes of the excise tax. It is separate from the computation period used for income tax purposes.

This interpretation thus would treat NAV method calculations for excise tax purposes consistently with the excise tax calculations for mark-to-market items. As such, it should allow RICs to account correctly for gains and losses for both tax and excise purposes.

⁶ If a RIC has a tax year ending November 30 or December 31, the RIC is permitted to elect to measure capital gain net income for excise tax purposes based on its tax year rather than the one-year period ending October 31. A RIC that makes such an election thus would use its tax year as the mark-to-market period for both tax and excise purposes. The remainder of this section assumes that a RIC has not made this election.

As an alternative to this approach, a RIC could apply the NAV method by using monthly (or even daily) computation periods for both income tax and excise tax purposes. This approach clearly is permissible under the proposed regulations, which requires that computation periods be of approximately equal duration (except for initial or final computation periods in a taxable year).⁷

Either of these two methods will ensure that RICs recognize and distribute the proper amounts for both income tax and excise tax purposes. For example, assume a RIC has a 6/30 fiscal year-end. The RIC buys into a floating NAV money market fund for \$10,000 on 7/1/2016. For purposes of simplicity, the RIC makes no further investments (including reinvestments) and does not sell any of the money market fund shares during the years in question. Assume further that this RIC holds no other assets.

The money market fund has the following change in value of its shares:

+\$4	+\$6	+\$5	+\$8
7/1/16	10/31/16	6/30/17	10/31/17
			6/30/18 FYE

If the RIC uses an 11/1 - 10/31 period for excise purposes and a 7/1 - 6/30 period for income tax purposes, it would have the following amounts of gain:

- For the excise tax year ending 10/31/16: Ending Value of \$10,004 minus starting value of \$10,000 minus net investment of \$0 = \$4 gain. The RIC will distribute \$4 of capital gain by calendar year-end to meet its excise tax distribution requirement.⁸
- For the tax year ending 6/30/17: Ending value of \$10,010 minus starting value of \$10,000 minus net investment of \$0 = \$10 gain. The RIC already has distributed \$4 of capital gain (for excise), leaving \$6 of capital gain that the RIC will distribute either prior to its tax year end or through a spillback distribution.
- For the excise tax year ending 10/31/17: Ending value of \$10,015 minus starting value of \$10,004 minus net investment of \$0 = \$11 gain. The RIC must distribute \$11 of capital gain for excise tax purposes by calendar year-end 2017 (including the \$6 of gain from 10/31/17 - 6/30/17 not already distributed, plus the \$5 of gain from 6/30/17 - 10/31/17).
- For the tax year ending 6/30/18: Ending value of \$10,023 minus starting value of \$10,010 minus net investment of \$0 = \$13 gain. The RIC already distributed \$5 of

⁷ Prop. Treas. Reg. § 1.446-7(b)(1)(i).

⁸ For simplicity, we assume that the RIC must distribute 100% of its capital gain net income to avoid excise tax.

pre-November gain for excise tax purposes, leaving \$8 of gain that the RIC will distribute either prior to tax year-end or through a spillback distribution.

Alternatively, the RIC could instead use monthly computation periods for both income tax and excise tax purposes. If it did so it would have the following amounts of gain:

- For the four monthly periods between 7/1/16 and 10/31/16: Total ending value of \$10,004 minus starting basis of \$10,000 minus net investment of \$0 = \$4 total gain for both income tax and excise tax purposes.⁹ The RIC will distribute \$4 of capital gain by calendar year-end.
- For the eight monthly periods between 11/1/16 and 6/30/17: Total ending value of \$10,010 minus starting value of \$10,004 minus net investment of \$0 = \$6 total gain that the RIC will distribute either prior to tax year-end or through a spillback distribution.¹⁰ This \$6 of gain plus \$4 from the prior periods equals the RIC's \$10 of capital gain for income tax purposes for the tax year ending 6/30/17.
- For the four monthly periods between 7/1/17 and 10/31/17: Total ending value of \$10,015 minus starting value of \$10,010 minus net investment of \$0 = \$5 of total gain. This \$5 of gain plus the \$6 of gain from the prior periods equals the RIC's \$11 of capital gain for excise tax purposes. The RIC distributes \$11 of capital gain by the end of calendar year 2017.
- For the eight monthly periods between 11/1/17 and 6/30/18: Total ending value of \$10,023 minus starting value of \$10,015 minus net investment of \$0 = \$8 total gain. This \$8 plus the \$5 of capital gain from the pre-November periods equals \$13 of capital gain for income tax purposes for the tax year.

We believe that the proposed regulations permit both approaches for calculating gains and losses for excise purposes using the NAV method. The monthly approach clearly is contemplated by the proposed regulations, which allows for multiple computation periods of approximately equal duration. The first approach also is consistent with the wording and intent of the proposed regulations,

⁹ For purposes of this example, assume that the value of the money market fund shares increases by \$1 each month. Thus, for the monthly period ending 7/31/16, the fund would have \$1 of gain (\$10,001 ending value minus starting basis of \$10,000); for the monthly period ending 8/31/16, the fund would have \$1 of gain (\$10,002 ending value minus starting basis of \$10,001); for the monthly period ending 9/30/16, the fund would have \$1 of gain (\$10,003 ending value minus starting basis of \$10,002); and for the monthly period ending 10/31/16, the fund would have \$1 of gain (\$10,004 ending value minus \$10,003 starting basis).

¹⁰ As described in note 9 above, assume that the money market fund shares increase in value equally over each monthly period. The RIC calculates the gain or loss for each monthly period by determining the fair market value at the end of each monthly period and subtracting (1) the fair market value at the start of each monthly period and (2) the net investment for that monthly period.

and it is consistent with how RICs currently treat mark-to-market items. Therefore, we ask the IRS and Treasury Department simply to confirm that the one-year period ending on October 31 may be used as the computation period for excise purposes, even if the fund uses a different calculation period for tax purposes.¹¹

Definition of Fair Market Value

At the public hearing, the government asked for the Institute's views on comments made by one of our members regarding the definition of "fair market value" in the proposed regulations. Specifically, the comment letter recommended that the final regulations clarify that the fair market value of a money market fund should be determined based on the NAV per share information that is published by the fund, *i.e.*, the published NAV per share as of the end of the relevant day (or the next trading day if the day in question is not a trading day).¹²

The Institute agrees with this clarification, with one important change. We understand that, in order to continue to accommodate same-day settlement in money market funds with floating NAVs, institutional funds are considering striking several NAVs throughout the day.¹³ Therefore, we recommend that "fair market value" for purposes of the NAV method be defined as the *next published* NAV per share, rather than the NAV as of the end of the relevant day. This should provide flexibility for funds that choose to publish more than one NAV per day while providing certainty as to the meaning of "fair market value" for purposes of the NAV method.

Clarifying that the fair market value is the next published NAV will make the proposed regulations workable from an administrative perspective. Basing fair market value on the next published NAV per share is the correct approach for at least three reasons. First, the published NAV per share reflects economic reality because it represents the price at which fund shares are purchased and redeemed. Second, it is highly unlikely that there will be a better or more reliable indicator of fair market value that is available to either fund shareholders or the IRS. Finally, published NAV per share will be easily accessible to both fund shareholders and the IRS, which will make the NAV method much easier for shareholders to apply and for the IRS to audit.

¹¹ Because using two separate calculation periods for excise and tax purposes is consistent with the proposed regulations, the IRS and Treasury Department would not need to modify the final regulations necessarily but instead could just confirm in the Preamble that this approach is permissible.

¹² See Letter from George C. Howell III re Floating Net Asset Value Money Market Funds – Comments on Proposed Treasury Regulations §§ 1.446-7 and 1.6045-1, dated October 27, 2014.

¹³ Currently, most institutional prime money market funds are settled on a T+0 basis, which is feasible due to the \$1 stable NAV. Retail money market funds generally are settled on a T+1 basis, and funds that are not money market funds (and therefore do not have stable NAVs) settle between T+1 and T+3. Institutional money market funds likely will wish to continue to provide T+0 settlement even with a floating NAV; thus, they may choose to calculate, apply, and publish multiple NAVs throughout the day.

Requiring fund shareholders to determine a fair market value for their shares that potentially is different from the published NAV per share would create significant administrative burden. The information necessary to make this separate valuation often would not be readily available, if available at all, to fund shareholders. Consequently, we recommend that the proposed regulations be revised to clarify that the fair market value of a money market fund share is the next published NAV per share.

Tax-Free Divisions of Money Market Funds

The Institute recommended in our comment letter that the Treasury Department and the IRS issue guidance permitting a Non-Government Money Market Fund (defined below) with both retail and institutional shareholders to divide into separate retail-only and institutional funds on a tax-free basis prior to the compliance date of the floating NAV provisions of the new money market fund rules adopted by the SEC. At the public hearing, the IRS requested that the Institute make an additional written submission to supplement the October letter and the November testimony and outline the associated reasoning. The discussion below addresses this issue.

A. Need for Non-Government Money Market Fund Divisions

In accordance with the new SEC rules, a Non-Government Money Market Fund that has retail and institutional shareholders and wants to maintain both its existing investment strategy and a stable \$1.00 NAV for retail shareholders effectively is required to divide itself into a retail-only fund and an institutional fund (or otherwise redeem all of the institutional shareholders).

Historically, money market funds have priced and transacted shares at a stable two-decimal-place (\$1.00) NAV. As of the compliance date of the floating NAV provisions of the new SEC rules, certain money market funds will be required to price and transact shares using a floating four-decimal-place NAV, while other money market funds will be permitted to continue to price and transact shares using a stable \$1.00 NAV. The determination of whether a money market fund will be permitted to use a stable NAV or required to use a floating NAV depends on the composition of the fund's assets, and in some cases, the composition of the fund's shareholder base.

Under the new SEC rules, a money market fund that invests 99.5% or more of its total assets in cash, securities issued by the U.S. Treasury and U.S. government agencies, and/or repurchase agreements that are collateralized fully by such securities (a "Government Money Market Fund") will be eligible to use a stable NAV. A money market fund that does not constitute a Government Money Market Fund (a "Non-Government Money Market Fund") also will be eligible to use a stable \$1.00 NAV if the fund has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons (*i.e.*, retail investors). A Non-Government Money Market Fund that permits

institutional shareholders (*i.e.*, non-retail investors, such as corporations) will be required to use a floating NAV.¹⁴

As a result, a fund complex that wants to offer a Non-Government Money Market Fund with a stable NAV to retail shareholders will need to exclude institutional shareholders from that fund. The complex will need to have a separate Non-Government Money Market Fund with a floating NAV if it also wants to offer a Non-Government Money Market Fund to institutional shareholders. Many fund complexes have existing Non-Government Money Market Funds with stable NAVs that are owned by both retail and institutional shareholders. These complexes thus will need to divide the existing fund into a stable NAV retail fund and a floating NAV institutional fund in order to achieve the separate fund structure just described.

The SEC was aware that the new rules would encourage the separate fund structure and would lead to divisions of existing Non-Government Money Market Funds. In response, the SEC has exercised its authority to facilitate these divisions. It has permitted money market funds to reorganize into separate funds for retail and institutional investors without seeking exemptive relief from sections 17(a), 18 and 22(e) of the Investment Company Act of 1940 (the "1940 Act").¹⁵ A fund may do so provided that the fund's board of directors, including a majority of the independent directors, determines that the reorganization results in a "fair and approximately pro rata allocation of the fund's assets between the class being reorganized and the class remaining in the fund."¹⁶

As anticipated, fund complexes are considering these sorts of Non-Government Money Market Fund divisions. These fund complexes thus need to (i) determine the tax consequences of such a division, (ii) factor those tax consequences into their decision on whether to proceed with a potential division, (iii) apprise the fund's board of directors of those tax consequences so that the board of directors can consider those consequences when deciding whether to approve the division, and (iv) explain the tax consequences to shareholders. As noted above (and described in more detail below), the Institute recommends that the Treasury Department and the IRS issue guidance treating these divisions as tax-free transactions if completed prior to the compliance date of the floating NAV

¹⁴ See Money Market Fund Reform: Form PF, Investment Company Release No. 31,166 (Jul. 23, 2014), at 202-242.

¹⁵ *Id.* at 228-232.

¹⁶ *Id.* at 230. Pursuant to this relief, a fund also may involuntarily redeem investors who no longer meet the eligibility requirements in the fund's retail and/or institutional money market funds, provided that the fund provides written notice to such investors at least 60 days before the redemption occurs. If the institutional shareholders' pro rata share of the applicable existing Non-Government Money Market Fund's assets is not large enough to constitute a viable standalone fund, then the division into two standalone funds may not be feasible and institutional shareholders potentially could be involuntarily redeemed. In those circumstances, the redemption clearly is a taxable transaction at the institutional shareholder level. Given that we expect such redemptions typically would be cash redemptions (rather than in-kind redemptions), we do not believe that they raise the level of tax complexity that a division into standalone funds would present, as there should be no gain or loss for shareholders because of the stable NAV. Further, there is no question as to whether gain is recognized by the fund on the distributed assets.

provisions of the new SEC rules. It is true that any gains or losses that may be recognized if these divisions were treated as taxable transactions likely would be small based on the nature of money market funds. The guidance, however, would be helpful to the fund industry in eliminating uncertainty with respect to the appropriate tax treatment of the divisions, minimizing the impacts of the divisions to funds and shareholders, and making shareholders' transition to the new money market fund environment as seamless as possible while reducing the risk of shareholder confusion. As noted above, the SEC already has exercised its authority to facilitate divisions in response to the SEC rules. The Institute asks the IRS and Treasury Department to do the same.

B. Mechanics of a Non-Government Money Market Fund Division

The mechanics of a money market fund division (referred to hereafter as a "Split-Off Transaction") are fairly straightforward. The existing money market fund (the "Existing MMF") would contribute a portion of its assets to a new money market fund (the "New MMF") in exchange for all of the shares of the New MMF. The Existing MMF then would distribute all of the New MMF shares to one category of its shareholders (*e.g.*, the institutional shareholders) in complete redemption of those shareholders' Existing MMF shares.¹⁷ The Existing MMF thus would become a standalone fund for one category of shareholders (*e.g.*, the retail shareholders) and the New MMF would become a standalone fund for the other category of shareholders (*e.g.*, the institutional shareholders).

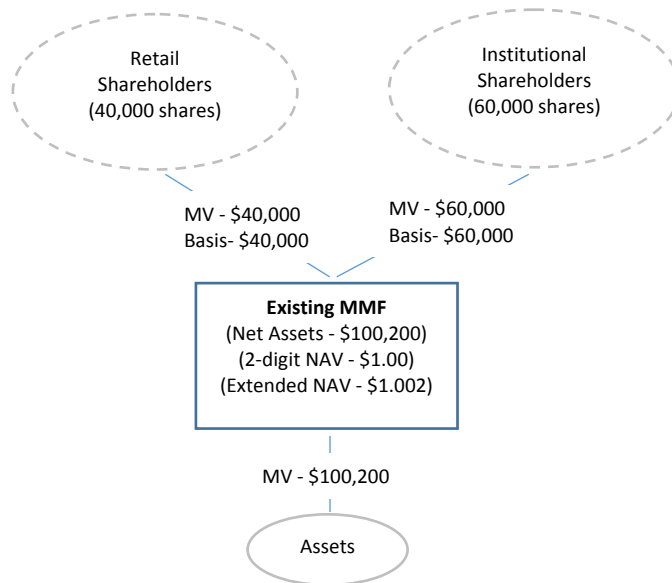
Any Split-Off Transaction would be processed in conformity with the SEC relief described above. Accordingly, the assets contributed to the New MMF would represent a "fair and approximately pro rata allocation" of the Existing MMF's assets.

It is expected that the Split-Off Transaction would occur in advance of the compliance date of the floating NAV provisions of the new SEC rules. Accordingly, the Existing MMF would price and transact shares using a stable \$1.00 NAV at the time of the Split-Off Transaction, and the Split-Off Transaction would be processed based on a stable \$1.00 NAV. The number of New MMF shares received by the Existing MMF on the contribution of assets and then distributed to the redeemed shareholders would be exactly equal to the number of Existing MMF shares held by those redeemed shareholders immediately prior to the Split-Off Transaction. Both the Existing MMF and the New MMF would price and transact shares using a stable \$1.00 NAV for a period of time between the

¹⁷ This type of division in which shareholders of an existing corporation surrender shares in the existing corporation in exchange for shares of a subsidiary is commonly referred to as a "split-off." As an alternative, the Existing MMF could form two new funds, distribute the shares of one new fund to the retail shareholders and the other new fund to institutional shareholders, and then liquidate. This type of division would be what is commonly referred to as a "split-up." The third common type of corporate division, known as a "spin-off" would involve the distribution of the single new fund to all of the Existing MMF shareholders and would not achieve the objective of getting the institutional shareholders into a separate fund from the retail shareholders.

closing of the Split-Off Transaction and the compliance date of floating NAV provisions of the SEC rules,¹⁸ before whichever fund is going to act as the institutional fund transitions to a floating NAV.

Example. Assume that the Existing MMF has net assets of \$100,200 and 100,000 shares outstanding immediately prior to the Split-Off Transaction (and thus has an extended NAV of \$1.002, but prices and transacts shares at a stable 2-digit NAV of \$1.00).¹⁹ Assume also that 40,000 of the 100,000 shares are held by retail investors and the other 60,000 are held by institutional investors.



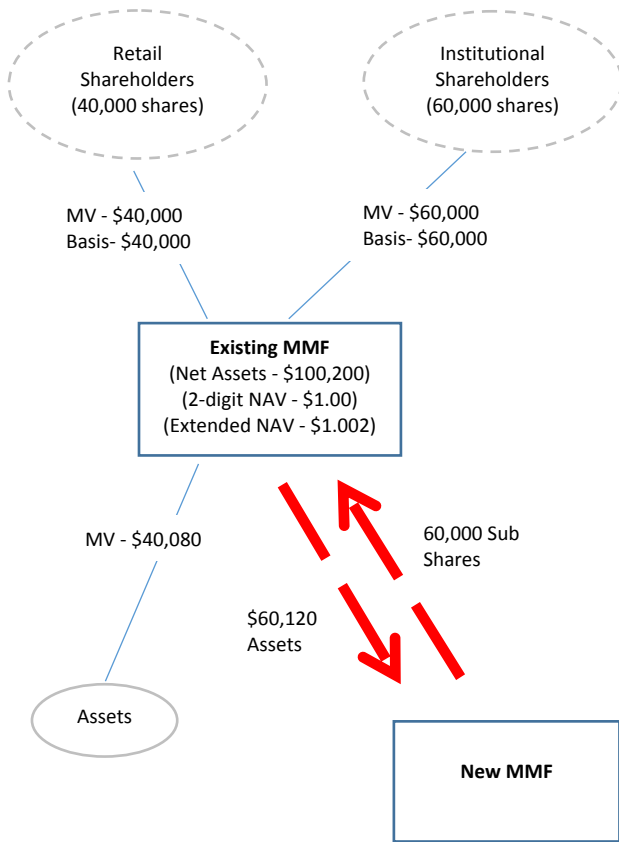
In this case, assuming that the Existing MMF is going to become the retail-only fund, the Existing MMF would contribute \$60,120 (60%) of its assets to New MMF in exchange for 60,000 New MMF shares. Existing MMF then would distribute those 60,000 New MMF shares (which have a NAV of \$1.00 per share and \$60,000 in total) to its institutional shareholders in redemption of their 60,000 Existing MMF shares (which also have a NAV of \$1.00 per share and \$60,000 in total).²⁰

¹⁸ For some funds, we believe that this period will be a month or longer. Conversely, in some cases, the institutional fund (the New MMF or Existing MMF as applicable) may elect to begin transacting at a floating NAV upon the next business day following the conclusion of the Split-Off Transaction.

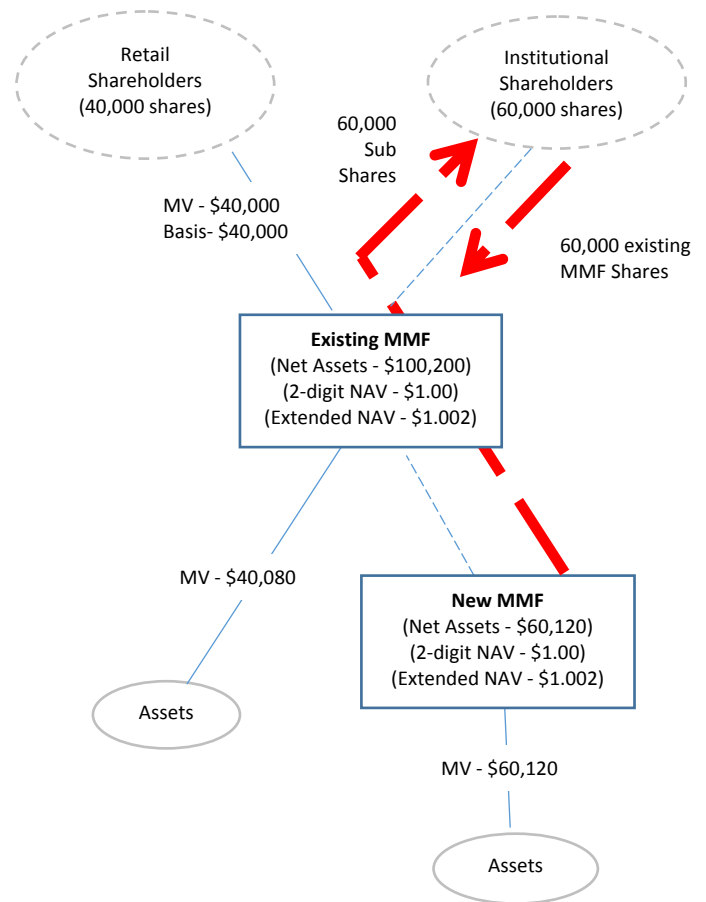
¹⁹ This example and all subsequent examples assume for simplicity that the Existing MMF has a single class of shares outstanding.

²⁰ If the facts were the same except that the Existing MMF had net assets of \$99,800 prior to the division (and thus had an extended NAV of \$0.998, but priced and transacted shares at a stable 2-digit NAV of \$1.00), then (assuming that the Existing MMF is going to become the retail-only fund) the Existing MMF would contribute \$59,880 of its assets to New MMF in exchange for 60,000 New MMF shares, and then Existing MMF would distribute those 60,000 New MMF shares to its institutional shareholders in redemption of their 60,000 Existing MMF shares.

Contribution Step



Distribution Step



C. Consequences of Tax-Free Treatment and Significance of Relief

As noted above, the Institute recommends that the IRS and Treasury Department issue guidance providing that a Split-Off Transaction (as described in the preceding section) will be treated as a tax-free transaction. Under the recommended guidance, the Split-Off Transaction could be treated explicitly as a tax-free reorganization under sections 355 and 368(a)(1)(D) (a “D reorganization”) or otherwise could be deemed to have the same tax consequences as a “D” reorganization.²¹ These tax consequences are as follows:

²¹ As discussed in section C.4. below, the Institute also recommends that the guidance provide an exemption from any shareholder reporting requirements that might otherwise apply as a result of the transaction.

- (1) No gain or loss is recognized by the Existing MMF or the New MMF upon the contribution of assets by Existing MMF to the New MMF in exchange for all of the New MMF shares;²²
- (2) The Existing MMF's basis and holding period in its assets carry over to the New MMF;
- (3) No gain or loss is recognized by the Existing MMF upon the distribution of the New MMF shares to the applicable category of its shareholders (*i.e.*, the retail or institutional shareholders) in redemption of their Existing MMF shares.
- (4) No gain or loss is recognized by the redeemed shareholders upon their receipt of the New MMF shares in redemption of their Existing MMF shares.
- (5) The redeemed shareholders' basis in the New MMF shares that they receive will be the same as their basis in the Existing MMF shares they surrender.
- (6) The redeemed shareholders' holding period in their Existing MMF shares carries over to the New MMF shares that they receive.

When evaluating these potential tax consequences and considering the advisability of issuing the recommended guidance, it is helpful to begin by considering the tax treatment of the Split-Off Transaction if it were not considered (or otherwise deemed to have the same consequences as) a D reorganization so as to highlight what the recommended guidance would be clarifying.

1. Potential Tax Consequences of the Contribution of Assets to the New MMF

The contribution of assets by the Existing MMF to the New MMF in exchange for all of the shares of the New MMF would qualify for tax-free treatment under sections 351 and 1032 regardless of whether the Split-Off Transaction as a whole were treated as (or like) a D reorganization.

Under section 351(a), no gain or loss is recognized when property is transferred to a corporation in exchange for its stock if the transferor is (or the transferors as a group are) in control²³ of the transferee corporation immediately after the exchange. The transfer of assets by the Existing MMF to the New MMF in exchange for all of the shares of the New MMF clearly satisfies those requirements. Based on section 351(c), the fact that the Existing MMF distributes all of the New MMF shares does not prevent the Existing MMF from having the requisite control immediately after the exchange²⁴ and

²² See note 27 below regarding possible recognition of ordinary income if a debt instrument with accrued but unrecognized market discount were contributed to the New MMF.

²³ For this purpose, "control" means that they own at least 80% of the voting power of all of the corporation's voting stock and own at least 80% of the total number of shares of all other classes of stock of the corporation.

²⁴ Section 351(c) provides that the distribution by a corporate transferor to its shareholders of all or a portion of the stock received in the exchange is not taken in determining whether the "control" requirement is satisfied. Accordingly, the fact

thus the contribution of assets to the New MMF would qualify for non-recognition treatment under section 351.²⁵

If the distribution of the New MMF shares by the Existing MMF to one category of its investors in redemption of their Existing MMF shares meets the requirements of section 355, then the contribution of assets to the New MMF also would qualify for nonrecognition treatment under section 368(a)(1)(D).²⁶ Regardless of whether the Treasury Department and the IRS issue the recommended guidance, the Existing MMF would not recognize gain or loss upon the contribution of assets to the New MMF.²⁷ Furthermore, under section 1032, the New MMF would not recognize gain or loss on that transaction.²⁸

In addition, the Existing MMF's basis and holding period in the contributed assets would carry over to the New MMF regardless of whether the IRS and the Treasury Department issue the recommended guidance.²⁹

that the Existing MMF distributes all of the New MMF shares to one category of its shareholders (*i.e.*, institutional or retail) does not prevent the satisfaction of the control requirement or the qualification of the contribution of assets to the New MMF as a tax-free contribution under Section 351. The requirement that the corporation's distribution be to "its shareholders" has been interpreted to allow distributions to less than all of the corporation's shareholders. *See, e.g.*, GCM 39138.

²⁵ Section 351 and the associated Treasury regulations contain an exception under which a transfer to an "investment company" is not tax-free if it results in the diversification of the transferor's interests. Under these circumstances, where a single transferor is transferring assets to a newly formed corporation in exchange for all of the new corporation's shares, that exception is not applicable.

²⁶ Under section 368(a)(1)(D), a transfer by a corporation of all or part of its assets to another corporation is treated as a tax-free reorganization if immediately after the transfer the transferor and/or one or more of its shareholders is in control of the transferee corporation and if in pursuance of the plan stock or securities of the corporation to which the assets are transferred are distributed in a transaction to which section 354, 355 or 356 applies.

²⁷ We note that while the contribution of assets in the Contribution Step will be a tax-free transaction, the Existing MMF technically would be required to recognize ordinary income (notwithstanding the general tax-free treatment) to the extent of the lesser of (i) accrued but unrecognized market discount and (ii) gain realized on any debt instrument contributed to the New MMF. Section 1276(a)(1) provides for this general result (*i.e.*, that market discount recognition trumps any other applicable nonrecognition rule). Although section 1276(d) overrides this default rule in the case of many nonrecognition transactions (thereby allowing the applicable nonrecognition rule to govern), it does not override it with respect to market discount bonds contributed in section 351 transactions (apparently regardless of whether the contribution also constitutes part of a D reorganization). We believe that most money market funds do not have meaningful exposure to this issue, as most taxable money market funds elect to include accrued market discount in income currently under section 1278(b), and most tax-exempt money market funds either elect to do the same or avoid holding market discount bonds.

²⁸ Under section 1032, a corporation does not recognize gain or loss on the receipt of property in exchange of its stock.

²⁹ If the contributed assets have a net built-in loss at the time of the contribution, then certain basis adjustments are required to prevent the duplication of losses. Either the transferee's (in this case, the New MMF's) aggregate basis in the assets received must be limited to the fair market value of those assets immediately after the contribution or the transferor's (in this case, the Existing MMF's) aggregate basis in the stock received must be limited to the fair market value of that stock

Accordingly, the Institute believes that existing law already permits the Existing MMF to contribute assets to the New MMF in a tax-free manner.

2. Potential Tax Consequences to the Existing MMF of its Distribution of New MMF Shares

If the Split-Off Transaction were treated as (or like) a D reorganization then, under section 361(c), the Existing MMF would not recognize gain or loss on the distribution of the New MMF shares to one category of its investors (*i.e.*, the institutional investors or the retail investors) in complete redemption of those investors' Existing MMF shares.

If the Split-Off Transaction were not treated as (or like) a D reorganization, then the Existing MMF still could avoid recognition of gain or loss on the distribution of New MMF shares if section 852(b)(6) were applicable to the distribution. Under section 311, a corporation (including a RIC) does not recognize loss if it makes a distribution of depreciated property to its shareholders, but generally does recognize gain if it makes a distribution of appreciated property to its shareholders. Section 852(b)(6) provides, however, that the section 311 gain-recognition rule does not apply to a distribution made by a RIC in redemption of its stock "upon the demand of the shareholder."

The phrase "upon the demand of the shareholder" is not defined for purposes of section 852(b)(6), and thus the full scope of section 852(b)(6) is not entirely clear. Section 852(b)(6) clearly applies to a distribution made in response to a shareholder exercising its unilateral right to redeem its shares of an open-end RIC under section 22(e) of the 1940 Act, but in the Split-Off Transaction shareholders receiving the distribution in question generally will not have formally exercised their section 22(e) redemption rights. The IRS has ruled privately, however, that section 852(b)(6) applies more broadly, *i.e.*, to distributions other than those made in response to shareholders exercising their section 22(e) redemption rights, and generally has taken an expansive view with respect to what "upon the demand of the shareholder" means.

PLR 200023031 addresses facts similar to the Split-Off Transactions. In that ruling, a fund proposed to split-off one of its share classes in order to create separate funds for institutional investors and retirement investors. The existing fund contributed a pro rata portion of its assets to a new fund in exchange for shares of the new fund and then distributed the new fund shares to the retirement investors in exchange for their existing fund shares. The ruling does not address whether the split-off would be a tax-free D reorganization, but it does address whether section 852(b)(6) would apply to prevent the existing fund from recognizing gain on the distribution of new fund shares in redemption of the retirement investors' existing fund shares. The IRS concluded that the "upon the demand of the shareholder" requirement was satisfied and section 852(b)(6) was applicable, reasoning that the proposed split-off required the approval of the retirement investors by shareholder vote, and that the retirement investors were collectively exercising their redemption right by approving the transaction.

immediately after the contribution. The statement above assumes that, in a net built-in loss scenario, the Existing MMF and the New MMF would elect to apply the basis reduction (to FMV) to the New MMF shares received by the Existing MMF.

Based on the SEC relief described above, however, the Split-Off Transactions discussed herein do not require a shareholder vote and instead require approval of the fund's board of directors. Assuming that the applicable Existing MMF opts not to hold a shareholder vote,³⁰ the facts of PLR 200023031 are not directly analogous to the Split-Off Transactions, and it is not clear that the reasoning of the ruling is applicable. Nevertheless, we believe that section 852(b)(6) should be viewed as applicable in the context of the Split-Off Transaction. The IRS has taken an expansive view of the scope of section 852(b)(6) in other circumstances; for example, it has applied section 852(b)(6) in connection with redemptions made by closed-end funds (which are really at the request, not the demand, of the shareholder).³¹ We believe that a Split-Off Transaction is equally worthy of application of section 852(b)(6), given the circumstances and the general policy concerns underlying section 852(b)(6).

Further, approval by the board of directors of the Split-Off Transactions reasonably could be viewed as a proxy for a shareholder vote and thus a proxy for the collective exercise of the shareholders' redemption rights. It also is arguable that the "upon demand of the shareholder" requirement should be deemed satisfied (and thus section 852(b)(6) should be deemed applicable) to any distribution made by an open-end RIC in redemption of its shares. Some support for this argument can in fact be found in PLR 200023031, which states:

Section 852(b)(6) does not define the term "redemption upon demand" of a shareholder. Elsewhere in the tax law, the term has been read to apply to redemptions of stock in an open-end regulated investment company. *Cf.* Section 162(k)(2)(B); H.R. Conf. Rep. No. 99- 841, 99th Cong., 2d Sess., at 168.³²

The application of section 852(b)(6) to the Split-Off Transactions also would be consistent with the policies underlying section 852(b)(6). One of the leading treatises on mutual fund taxation states that the apparent purpose of section 852(b)(6) is to prevent the tax treatment normally applicable to corporate distributions of appreciated property from undermining the purpose of section 2(a)(32) of the 1940 Act, which permits open-end registered investment companies to meet redemption demands with in-kind distributions.³³ The 1940 Act rule is intended to allow open-end investment companies to avoid having to make forced sales of their securities, as could otherwise be required if redemptions had to be satisfied with cash distributions. This purpose would be undermined if RICs were required to recognize gain on distributions of appreciated property, given that (to avoid

³⁰ Given that the shareholder vote is not required by the SEC and that holding a shareholder vote could delay a transaction that will need to be expedited in light of the looming compliance date for the floating NAV provisions of the new SEC rules, it could be problematic for a fund complex to hold a shareholder vote in order to strengthen the argument for applicability of section 852(b)(6).

³¹ *See, e.g.*, PLR 200536002.

³² Similar statements have been made in other private letter rulings. *See, e.g.*, PLR 200536002.

³³ *See* S. Johnston, *Taxation of Regulated Investment Companies and Their Shareholders* (2nd ed.) at ¶3.06[2].

entity-level taxation on those gains) RICs would be forced either to make additional distributions of property (potentially triggering more gain recognition) or distributions of cash (potentially requiring security sales and more gain recognition).

A slightly more broadly stated version of the apparent purpose would be that, when a RIC is compelled by external forces to make a distribution in redemption of its shares, and securities law rules permit that distribution to be made in-kind, the RIC should be excepted from gain recognition on the distributed assets to prevent the distribution from triggering ancillary distribution and/or security-sale requirements. In the instant case, external forces (namely, the new SEC rules) effectively are compelling the distribution of New MMF shares in redemption of Existing MMF shares, and SEC relief permits the distribution to be made (without shareholders exercising their redemption right or participating in a shareholder vote). It does not seem appropriate for that distribution to trigger gain recognition and thus ancillary distribution and/or security sale requirements.

If section 852(b)(6) is not applicable, the Existing MMF would not recognize loss on the New MMF shares distributed; it would recognize gain on those shares only to the extent that the value of the New MMF shares exceeded the Existing MMF's basis in those shares. As noted above, the Existing MMF's basis in the New MMF shares generally would equal the Existing MMF's basis in the assets contributed to the New MMF in exchange for those shares, but could be stepped down to fair market value if the Existing MMF had a net built-in loss in the contributed assets.³⁴ It would seem appropriate for the value of the New MMF shares to be determined for this purpose based on their stable \$1.00 NAV redemption value as opposed to their extended NAV (*i.e.*, the value of the underlying assets).³⁵ If this is correct, then in the Example above, the value of the New MMF shares distributed would be \$60,000 and the Existing MMF would recognize no gain as long as its basis in the \$60,120 worth of assets contributed to New MMF was greater than or equal to \$60,000.³⁶

Based on the foregoing discussion, there is some uncertainty as to whether the Existing MMF would recognize gain on the distribution of New MMF shares (and, if so, how that gain should be calculated) if the Split-Off Transaction were not treated as (or like) a D reorganization. The Institute believes, however, that guidance providing that the Existing MMF recognizes no gain or loss on the distribution of New MMF shares would be consistent with current law. Specifically, the IRS and Treasury Department should conclude that section 852(b)(6) applies to the distribution, thereby eliminating gain recognition in the limited circumstance in which the value of the New MMF shares exceeds the Existing MMF's basis in those shares. We believe that these circumstances will occur

³⁴ Section 362(e).

³⁵ As discussed below, we believe that this is also the appropriate valuation for purposes of determining the tax treatment of the shareholder side of this same transaction.

³⁶ Alternatively, as described in note 20, the Existing MMF had net assets of \$99,800 prior to the division and contributed \$59,880 of those assets to New MMF in exchange for 60,000 New MMF shares, then this valuation methodology would clearly result in gain recognition at the Existing MMF level (assuming section 852(b)(6) is not applicable) if the Existing MMF's basis in the \$59,880 of assets contributed was less than \$60,000.

infrequently because the appropriate valuation for this purpose of each New MMF share distributed generally will be its stable \$1.00 NAV redemption value.

3. Potential Tax Consequences to the Redeemed Shareholders of their Receipt of New MMF Shares

If the Split-Off Transaction were treated as (or like) a D reorganization, under section 355, the redeemed shareholders would recognize no gain or loss upon their receipt of the New MMF shares in redemption of their Existing MMF shares. The redeemed shareholders' basis and holding period in their Existing MMF shares would carry over to the New MMF shares that they receive.

If the Split-Off Transaction were not treated as (or like) a D reorganization, the redeemed shareholders would be required to recognize gain or loss on the redemption of their Existing MMF shares and would take a fair market value basis and a new holding period in the New MMF shares received. Even if section 852(b)(6) applies (together with section 311(a)) to prevent gain or loss recognition at the Existing MMF level, there is no provision other than sections 355 and 368(a)(1)(D) that would protect the redeemed shareholders from recognizing gain or loss.

In the context of a money market fund division, even if the division does not qualify as a D reorganization and the redeemed shareholders technically are required to recognize gain or loss on the redemption, they would have no gain or loss to recognize in the transaction, provided that the New MMF shares are valued at \$1.00 per share for this purpose. As described above, the redeemed shareholders would exchange their Existing MMF shares (which have a NAV and basis of \$1.00 per share) for an equivalent number of New MMF shares. Accordingly, assuming that the New MMF shares are valued at \$1.00 per share, the value of the shares received would be exactly equal to the basis of the shares surrendered, and those shareholders should recognize no gain or loss.

From the perspective of the redeemed shareholders, the two-decimal \$1.00 NAV per share should be the appropriate valuation of the New MMF shares received. If the New MMF will become the retail-only fund, then the New MMF shares generally will continue to have the \$1.00 NAV per share indefinitely. That \$1.00 NAV per share thus represents the value that the shareholders would receive if they redeemed the New MMF shares immediately following the transaction. Because a redemption is the only way for a shareholder to dispose of the New MMF shares, that redemption value should be viewed as the market value of the shares for purposes of determining gain or loss recognized in the transaction. If the New MMF will become the institutional fund, then the New MMF shares received eventually will have a floating NAV, at which point their value likely will diverge from their basis. Assuming that the beginning of the floating NAV is sufficiently remote from the Split-Off Transaction, however, the \$1.00 NAV per share still would be the value at which those shareholders could redeem the New MMF shares immediately following the transaction and thus the appropriate market value of the shares for purposes of determining gain or loss recognized in the transaction. We expect that many Split-Off Transactions will fall into one of these two categories (*i.e.*, the New MMF will become the retail-only fund or the New MMF will retain a stable two-decimal NAV for a period of

time following the transaction³⁷), in which case the New MMF shares clearly should be valued at the two-decimal \$1.00 per share. Using an extended (*i.e.*, four-decimal) NAV would be inappropriate.³⁸

It is possible that some fund sponsors who split-off the institutional investors into the New MMF may decide to begin floating the NAV upon the next business day following the Split-Off Transaction. In this case, the value at which the New MMF shareholders could redeem their shares on the business day following the transaction may be something other than \$1.0000 per share. In that limited context, there may be uncertainty as to whether the New MMF shares received should be valued for purposes of determining gain or loss recognized on the Split-Off Transaction at their \$1.00 NAV immediately prior to the transaction (resulting in no gain or loss to the shareholders) or at their extended four-decimal NAV immediately following the transaction (resulting in some amount of gain or loss to the shareholders). We believe that, in this context, the IRS and the Treasury Department still should treat these shareholders as exchanging shares worth \$1.00 each for shares worth \$1.00 each, resulting in no recognized gain or loss. Permitting funds to treat the New MMF shares as having a \$1.00 NAV would ease the administrative burden of a Split-Off Transaction for both shareholders and funds.

Although the redeemed shareholders' basis in their Existing MMF shares surrendered would not carry over to the New MMF shares redeemed if the Split-Off Transaction does not qualify as a D reorganization, the redeemed shareholders' basis in the New MMF shares received would equal their newly acquired cost of \$1.00 per share if the New MMF shares are valued at \$1.00 per share. The basis thus would be the same as the basis in the Existing MMF shares surrendered. The other substantive tax issue at stake for the redeemed shareholders in the determination of whether or not the Split-Off Transaction is treated as (or like) a D reorganization should be whether or not the redeemed shareholders' holding period in their Existing MMF shares surrendered carries over to the New MMF shares received. The redeemed shareholders' holding period in the New MMF shares received should have little or no impact on the tax liabilities of those shareholders. If the institutional shareholders are redeemed (and thus the New MMF will be the institutional fund), then gains or losses recognized by only a portion of those shareholders (*e.g.*, institutional shareholders that are partnerships or S corporations, to the extent that the gains and losses flow-through to individuals) would be subject to different tax rates depending on whether they are short-term or long-term gains and losses. Further,

³⁷ As noted above, we believe that in many cases where the New MMF will become the institutional fund, the New MMF will not institute a floating NAV for at least a month following the Split-Off Transaction.

³⁸ We note that, if in the Example we have been discussing, the 60,000 New MMF shares received by institutional shareholders of the Existing Fund were valued at their extended NAV for shareholder gain/loss purposes and thus had a total value of \$60,120 for shareholder gain/loss purposes, then those institutional shareholders would recognize \$120 of gain on the transaction and take the New MMF shares with a built-in loss of \$120. That treatment does not seem logical. If the institutional shareholder turned around and sold those shares they would realize that \$120 of loss, which could create some potential for abuse in that the gain recognized on the disposition of the Existing MMF shares could be long-term capital gain and the loss recognized on the immediate sale of the New MMF shares would be short-term capital loss. This character difference could be relevant in circumstances in which the institutional shareholder is a partnership or S corporation, to the extent that the gains and losses flow through to the individuals.

these different tax rates would not be relevant to such shareholders if they elect to use the NAV method, pursuant to which all gains and losses are treated as short-term capital gains or losses. The rest of the institutional shareholders (*e.g.*, C corporations) are not subject to different tax rates on their short-term and long-term gains. If the retail shareholders are redeemed (and thus the New MMF will become the retail-only fund), then the shareholders who get the holding period restart (*e.g.*, natural persons) will hold shares that should retain a stable \$1.00 NAV indefinitely; thus, subsequent sales of those shares generally should not result in recognition of gain or loss that potentially could be converted from long-term to short-term.³⁹

4. Recommended Guidance

From the taxpayers' standpoint, the simplest means for facilitating tax-free Split-Off Transactions would be for the IRS and Treasury Department to provide guidance permitting such transactions to qualify under sections 368(a)(1)(D) and 355. If the government is not comfortable with that conclusion, or it does not believe that it can issue the immediate guidance that is needed in this context, then the Institute recommends that the IRS issue a Revenue Procedure providing a safe harbor under which the IRS will not challenge taxpayers who treat a Split-Off Transaction as having the following tax consequences:

- (1) No gain or loss is recognized by the Existing MMF or the New MMF upon the contribution of assets by Existing MMF to the New MMF in exchange for all of the New MMF shares;⁴⁰
- (2) The Existing MMF's basis and holding period in its assets carry over to the New MMF;⁴¹
- (3) No gain or loss is recognized by the Existing MMF upon the distribution of the New MMF shares to the applicable category of its shareholders (*i.e.*, the retail or institutional shareholders) in redemption of their Existing MMF shares;⁴²
- (4) No gain or loss is recognized by the redeemed shareholders upon their receipt of the New MMF shares in redemption of their Existing MMF shares;⁴³

³⁹ One exception to that would be if the New MMF is the retail-only fund and imposes a liquidity fee within a year of the Split-Off Transaction, in which case the loss realized as a result of the liquidity fee by a shareholder who acquired New MMF shares in the Split-Off Transaction and redeemed those shares and incurred a liquidity fee would be short-term capital loss (whereas it may have been long-term capital loss if the shareholder's holding period from its Existing MMF shares carried over).

⁴⁰ Sections 351 and 1032.

⁴¹ *Id.*

⁴² Section 311(a) applies to prevent the recognition of any loss. We believe section 852(b)(6) also should apply to prevent the recognition of any gain.

- (5) The redeemed shareholders' basis in the New MMF shares that they receive will be the same as their basis in the Existing MMF shares they surrender;⁴⁴ and
- (6) The redeemed shareholders' holding period in their Existing MMF shares carries over to the New MMF shares that they receive.

As discussed above, much of this guidance would be consistent with and clarify the application of current law to a Split-Off Transaction.⁴⁵

This guidance would be very helpful to the fund industry and its shareholders in eliminating uncertainty with respect to the appropriate tax treatment of money market fund divisions occurring prior to the compliance date for the floating NAV provisions of the SEC rules. It would minimize the impact of the divisions to funds and shareholders and make shareholders' transition to the new money market fund environment as seamless as possible while reducing the risk of shareholder confusion.

The IRS very helpfully has addressed other challenging money market fund-related tax issues in a similar manner (*e.g.*, wash sales on money market fund shares in Rev. Proc. 2014-45 and contributions to money market funds by advisors in Rev. Proc. 2009-10). The Institute believes that Split-Off Transactions pursuant to the new SEC money market fund rule warrant a similar form of relief.

The requested guidance can be limited in scope to address only divisions of Non-Government Money Market Funds prior to the compliance date for the floating NAV provisions of the new money market fund rules adopted by the SEC.

The Institute also requests that, in addition to providing for the tax consequences described above, the guidance include clarification that shareholders are not required to report the Split-Off Transaction on their tax returns or file any tax statements with regard to the Split-Off Transaction. If the Split-Off Transaction is a D reorganization, it does not appear that the significant shareholder statement requirements of Treas. Reg. §1.368-3 are applicable to split-off transactions. If the Split-Off Transaction were technically a taxable event for the redeemed shareholders, they would not recognize any gains or losses on the transaction. Consequently, there would be no practical purpose to shareholders reporting the transaction on their tax returns. Clarification that the reporting is not required, however, would be helpful.

⁴³ The value of the New MMF shares received (\$1.00 per share) will equal the basis in the Existing MMF shares surrendered (\$1.00 per share).

⁴⁴ The fair market value, and the basis, of the New MMF shares received will be \$1.00 per share.

⁴⁵ In essence, pursuant to the recommended guidance, the IRS would not challenge funds' tax positions that (a) section 852(b)(6) is applicable, (b) the New MMF shares are valued appropriately at the stable \$1.00 NAV for purposes of determining the tax consequences to redeemed shareholders, and (c) the redeemed shareholders' holding periods carry over to the New MMF shares.

D. Applicability of Section 355

As evidenced by the discussion of Split-Off Transactions at the public hearing, the IRS's focus historically has been on the question of whether a RIC could satisfy the active trade or business requirement in order for a split-off to qualify for tax-free treatment under sections 355 and 368(a)(1)(D). The IRS asked whether and how a RIC could satisfy the active trade or business requirement of section 355. The government also asked whether the Institute has submitted comments following the Treasury Department's issuance of proposed regulations in 2008 or the Treasury Department's inclusion of the active trade or business requirement on its Priority Guidance Plan.

In light of its resources and regulatory priorities, the Institute previously has not submitted formal comments on the active trade or business requirement, though we have discussed the issue informally with the IRS. The SEC money market fund rule has elevated this issue, at least with respect to funds that will be split into two funds in order to comply with the new rule. The Institute does not believe, however, that the Priority Guidance Plan and the associated regulatory project under section 355 is the place to address the issue and the guidance sought with respect to money market funds. The issue at hand is limited to Non-Government Money Market Funds, and that issue will exist only between now and the compliance date of the floating NAV provisions of the SEC rules. The requested guidance similarly is limited. Given the timing, we believe that the guidance must be addressed on a faster track than the section 355 regulatory project. Tax-free divisions of money market funds should be addressed with expediency similar to the money market fund-specific proposed regulations and revenue procedure that already have helpfully addressed many of the tax issues presented by new SEC money market fund rules.

With regard to whether and how a RIC can satisfy the active trade or business requirement, the Institute believes that a RIC (including a money market fund) can satisfy that requirement.⁴⁶ Before focusing on the technical requirements of section 355, we believe it is important to first consider the purpose of those technical requirements, and to keep that purpose in mind when thinking about the satisfaction of the technical requirements and the recommended guidance more generally.

At least one former Treasury Department attorney has noted that “[w]e think it is important to avoid looking at the separate requirements of section 355 without keeping in mind the overall purpose of preventing devices designed to bail out profits.”⁴⁷ That statement was made in connection with the consideration of a proposed ruling on whether a controlled subsidiary (Y) in the rental real estate business was engaged in the active conduct of trade or business if Y's business activities were performed by employees of a sister subsidiary who received no compensation from Y and by Y's officers who served without compensation and who were also officers of the sister subsidiary and the common parent. In

⁴⁶ The Institute also believes that the IRS and the Treasury Department can issue the recommended guidance without concluding on the active trade or business requirement, as discussed above.

⁴⁷ Memorandum dated December 8, 1975 from Dale S. Collinson, Tax Legislative Counsel Designate to Lawrence B. Gibbs Assistant Commissioner (Technical), attached to GCM 37968.

that context, the memorandum reiterated the importance of focusing on the purpose of the active conduct requirement and the abuses at which it is aimed by stating that “[w]e strongly believe that the finding of no active trade or business in this ruling would be contrary to this focus on the device clause and viewing the active trade or business requirement as a backstop thereto.”

As indicated above, the technical requirements of section 355 (and the active trade or business requirement in particular) are aimed at preventing devices designed to bail out earnings and profits. This applies to circumstances in which a corporation potentially could undermine the tax on dividend income that generally applies when a corporation distributes its earnings and profits to its shareholders. By transferring its profits to a new corporation and distributing the stock of the new corporation to its shareholders on a tax-free basis, an existing corporation could allow its shareholders to access those profits by way of a sale or liquidation of the new corporation rather than a taxable dividend from the existing corporation (with any gain recognized on the liquidation being taxed at capital gains rates).

This bail-out concern is inapplicable in the RIC context in general and in the money market fund context in particular. Because a RIC is required to distribute its income on an annual basis in order to avoid entity-level tax, the only income that theoretically could be “bailed out” in the RIC context should be the income earned in the year of the Split-Off Transaction. Further, a RIC shareholder who wanted to “bail out” that income and recognize it in the form of capital gain rather than dividend income could do so by simply redeeming his or her shares of the existing RIC without any need for a split-off. In the money market fund context, the absence of “bail out” concerns is even more pronounced given that money market funds declare distributions of their income on a daily (rather than an annual) basis, thus eliminating any income that theoretically could be bailed out.⁴⁸

The technical requirements of section 355 also serve to limit the extent to which section 355 can be used to make an end run around the repeal of the General Utilities doctrine. Following the repeal of the General Utilities doctrine, a corporation transferring property from corporate solution into the hands of a shareholder is required to recognize any gain in the distributed property, thus preserving a corporate-level of taxation on that gain. Given that section 355 allows corporations to distribute property (*i.e.*, the shares of the spun-off/split-off subsidiary) without recognizing the embedded gain, there is pressure on limiting the scope of section 355 and the technical requirements thereof in order to preserve the two-tier tax system applicable to corporations. This concern is inapplicable in the RIC context. As discussed above, RICs already are permitted to distribute property to shareholders without recognizing gain on that property under section 852(b)(6). In addition, RICs are not subject to an entity-level of tax (provided that they distribute their income and gains) and thus there is no entity-level of taxation to preserve.

⁴⁸ The fact that the Existing MMF and New MMF shares could only be redeemed at their \$1.00 NAV for a period of time following the Split-Off Transaction further supports the absence of “bail-out” concern with respect to income earned prior to the Split-Off Transaction.

Although the absence of any of the potential abuses against which the technical requirements of section 355 serve to protect may not be sufficient to conclude that the Split-Off Transactions should be treated as qualifying as a tax-free reorganization under sections 355 and 368(a)(1)(D), it should give the IRS and Treasury Department comfort that issuing the recommended guidance would not undermine the purpose of the technical requirements. It also ought to be factored into any analysis of whether a division of a money market fund (or any other RIC) satisfies those technical requirements and into the interpretation of the scope of those requirements for purposes of that analysis. The Institute believes that such an analysis leads to the conclusion that a money market fund Split-Off Transaction can satisfy the technical requirements of section 355, including the active trade or business requirement.

A money market fund Split-Off Transaction clearly should satisfy all of the section 355 requirements other than the active trade or business requirements (provided that the money market fund has been in operation for at least 5 years).⁴⁹ Although the question of whether a Split-Off Transaction can satisfy the active trade or business requirement (*i.e.*, that both the Existing MMF and the New MMF will be engaged in the active conduct of a trade or business immediately after the distribution) is a more difficult question, the Institute believes that a Split-Off Transaction can satisfy that requirement. Given, however, that the IRS and the Treasury Department can issue the recommended guidance without reaching a conclusion on the active trade or business requirement (as discussed above), and because that approach is likely the more expedient approach, we are not going to provide a comprehensive analysis of the active trade or business requirement in this letter. Instead, we will highlight key points.⁵⁰

As stated in a recent *Tax Notes* article: “A RIC is not simply a passive investment vehicle. Rather, a RIC is engaged in business as a financial intermediary that provides financial services and stands in the middle of a web of relationships involving its investments, its shareholders and its service providers.”⁵¹ In the course of engaging in that business, a RIC actively seeks to sell additional shares to existing and potential new shareholders (an activity that resembles that of a business seeking to obtain and retain the patronage of customers) so as to maintain and expand its investable capital. In so doing, a RIC⁵² continuously offers to issue and redeem its shares (making required regulatory filings, including prospectuses) and adopts a distribution and/or marketing plan for selling its shares (analogous to how

⁴⁹ These requirements are that (i) Existing MMF control New MMF immediately prior to the distribution, (ii) the transaction not be used principally as a device for the distribution of earnings and profits, (iii) Existing MMF distributes all of the New MMF stock that it held, (iv) there is a valid corporate business purpose for the transaction, (v) there is continuity of interest, and (vi) there is continuity of business enterprise. The 5-year requirement referenced in the parenthetical is an aspect of the active trade or business requirement.

⁵⁰ If the government is interested in a comprehensive analysis, we encourage them to read a recent report published in *Tax Notes* that includes a thoughtful and complete analysis of why RICs should be viewed as satisfying the active trade or business requirement. See Stephen D. Fisher, RIC-ity Split: Can a Mutual Fund Separate on a Tax-Free Basis, *Tax Notes*, November 19, 2014, 2015 TNT 3-1.

⁵¹ *Id.*

⁵² We are assuming here that the RIC in question is an open-end RIC, as are the money market funds in question.

an operating company sells various goods and services), which enables it to increase its capital inflows in order to continue to operate as a going concern.

A RIC provides active and professional investment management of the capital it accumulates. It has a board of trustees and typically officers that perform active and substantial management and operation functions. A RIC also provides a variety of additional services, including recordkeeping, tax reporting, custody arrangements, and other administrative services.⁵³

Some of those activities performed by a RIC could be thought of as similar to the activities of a bank, which the IRS has concluded is engaged in an active trade or business for purposes of section 355.⁵⁴ In fact, the perceived similarity of money market funds to banks appears to be part of what led to the new SEC rules applicable to money market funds, which, in turn, have led to the tax issues discussed herein.⁵⁵ It would seem particularly unfortunate for the perceived similarity to banks to lead to the new SEC rules applicable to money market funds, but for money market funds to be distinguished from banks (in terms of their satisfaction of the active trade or business requirement) when determining the tax treatment of transactions engaged in by money market funds in response to those new SEC rules.

It also is important to recognize that the limitation on investment activity in stock and securities satisfying the active business requirement under Treas. Reg. §1.355-3(b)(2)(iv) does not apply to RICs. Although a cursory reading of that regulation may suggest that activity related to owning and trading stocks and securities cannot constitute an active trade or business, a more careful reading reveals that it can under certain circumstances. Treas. Reg. §1.355-3(b)(2)(iv) provides that the active conduct of a trade or business does not include (A) the holding for investment purposes of stock, securities, land or other property, or (B) the ownership and operation of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property. The first prong of that regulation provides that the holding of stock and securities *for investment purposes* cannot constitute the active conduct of a trade or business. The second prong effectively provides that stock or securities (which are personal property) *used in a trade or business*

⁵³ It is true that most, if not all, of these activities and services are performed by third parties, such as investment advisors, distributors, and transfer agents, with whom the RIC has entered into management or service contracts. Treas. Reg. § 1.355-3(b)(2)(iii) provides that, “*Generally*, the activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors” (emphasis added). We do not believe, however, that this restriction precludes the conclusion that RICs are engaged in an active trade or business. For further discussion of this issue, *see* Fisher at 102.

⁵⁴ *See* PLR 201310023.

⁵⁵ *See* Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform (November 2012) (“The Council believes that MMFs are ‘predominantly engaged in financial activities’ as defined in section 4(k) of the Bank Holding Company Act of 1956 and thus are “nonbank financial companies” for purposes of Title I of the Dodd-Frank Act. . . . [T]he Council proposes to determine that the activities and practices of MMFs, for which the SEC is the primary financial regulatory agency, could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and the financial markets of the United States.”)

cannot constitute the active conduct of a trade or business, *unless the owner performs significant services with respect to the stock or securities*.⁵⁶ This means that there are circumstances in which ownership and “operation” of stock and securities can constitute the active conduct of a trade or business,⁵⁷ namely circumstances in which the owner performs significant services with respect to the stock or securities. As discussed above, a RIC performs such significant services (and does not merely hold the stock and securities for investment purposes).

The only authority that may appear contrary to this conclusion is Rev. Rul. 66-204, 1966-2 C.B. 113.⁵⁸ This guidance addressed the activities of a broker/dealer’s wholly owned subsidiary, which owned and managed an investment portfolio of stocks and bonds. The subsidiary’s employees performed research and analysis and related administrative tasks. The subsidiary’s income equaled 40% of the total combined income of the broker/dealer and its subsidiary. Despite the level of this activity, the IRS concluded that, “trading in stocks and securities held *for one’s own account* is an investment function and is not the active conduct of a trade or business within the meaning of Section 355 of the Code.” (Emphasis added.)⁵⁹ This conclusion, however, is not necessarily inconsistent with the conclusion that a mutual fund that actively solicits new investors and holds a portfolio that is actively and professionally managed for the accounts of others can be considered to be engaged in an active trade or business.

For the reasons described above and addressed in more detail in the report cited above,⁶⁰ the Institute believes that money market funds (and RICs more generally) do satisfy the active trade or business requirement and can satisfy the other technical requirements of section 355. Therefore, we believe there is no policy reason for preventing a money market fund (or a RIC more generally) from dividing on a tax-free basis.

⁵⁶ Treas. Reg. §1.355-3(c) *Example* (1) involves a corporation that is engaged in the manufacture and sale of soap and also owns investment securities. The example, citing Treas. Reg. §1.355-3(b)(2)(iv)(A), concludes that the corporation’s attempt to spin off the investment securities does not meet the requirements of section 355(b) because “the holding of *investment* securities does not constitute the active conduct of a trade or business.” (Emphasis added.) This conclusion is unsurprising; it is also inapposite to securities held in connection with a trade or business. Moreover, even if the securities in that example were considered to be held in a trade or business, the result would likely be the same; the facts of the example suggest that no “significant services” are rendered with respect to the securities.

⁵⁷ We note that one of the leading treatises on corporate taxation agrees with this conclusion. See B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed.) at ¶11.03[2], noting that Treas. Reg. §1.355-3(c) *Example* (1) could come out the other way because “[a] manufacturing corporation could be engaged in a trade or business of buying and selling securities.”

⁵⁸ See Fisher at 109.

⁵⁹ T.D. 8238, 1989-1 C.B. 92, which adopted the current Regulations under section 355, refers to Rev. Rul. 66-204 as authority for the position that “trading in stock and securities held *for one’s own account* is an investment function and is not the active conduct of a trade or business.” (Emphasis added.)

⁶⁰ See note 50 and accompanying text.

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The Institute and its members appreciate your attention to these matters, and we look forward to assisting you in any way. Please do not hesitate to contact me if you have any questions or concerns regarding the issues above or the proposed regulations more generally. I can be reached at (202) 371-5432 or kgibian@ici.org.

Sincerely,

/s/ Karen L Gibian

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