2016 INVESTMENT MANAGEMENT CONFERENCE

Federal Tax Aspects Affecting Mutual Funds

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REGULATED INVESTMENT COMPANIES (“RICs”)

- Open-end funds (“mutual funds”)
- Closed-end funds
- Most exchange-traded funds (“ETFs”)

Receive “pass-through” treatment under Subchapter M

REQUIREMENTS FOR RIC TREATMENT

- Domestic corporation (or entity classified as such)
- Registered under 1940 Act (or BDC election)
- Election to be a RIC – Form 1120-RIC
- Gross Income Requirement – 90% of gross income
  - Passive income
  - Net income derived from an interest in a “qualified publicly traded partnership”

REQUIREMENTS FOR RIC TREATMENT
(CONTINUED)

- Gross Income Requirement (continued)
  - Income from commodities
    - Revenue rulings; exceptions
    - Private letter rulings (suspended)
    - Proposed regulations
      - Income inclusions from CFCs and QEFs no longer qualifying income
      - Qualifying income therefrom limited to distributions
    - Revenue procedure – “ordinarily” will not issue PLRs for RIC treatment involving whether a financial instrument is a “security”
      - Existing PLRs regarding commodity-linked notes will be revoked and future such PLRs rare, if at all
    - RIC Modernization Act

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REQUIREMENTS FOR RIC TREATMENT
(CONTINUED)

- Diversification Requirements – close of each taxable year quarter (different from 1940 Act requirement)
  - 50% of assets
    - 5% of assets in a single issuer
    - 10% of a single issuer's voting securities
    - Specific instruments (including repos and Government securities)
  - 25% of assets

REQUIREMENTS FOR RIC TREATMENT
(CONTINUED)

- Diversification Requirements (continued)
  - No disqualification for certain failures to comply
    - Exception for market fluctuations and distributions
    - 30-day cure period
    - RIC Modernization Act – “inadvertent” failure (i.e., failure “due to reasonable cause and not due to willful neglect”) and *de minimis* failure

REQUIREMENTS FOR RIC TREATMENT
(CONTINUED)

- Distribution Requirement
  - 90% of investment company taxable income
    - Includes net short-term capital gain
    - Includes net foreign currency gains and losses
  - 90% of net tax-exempt income
  - Net capital gain
  - “Year-end Dividend Rule”

TAX TREATMENT OF SHAREHOLDERS

- Income Dividends
  - Qualified dividend income (individuals) – 15% and 20% maximum tax rates
  - Dividends-received deduction (corporations)
- Capital Gain Dividends
  - Former designation requirement (within 60 days after taxable year-end) replaced, by RIC Modernization Act, with reporting requirement
  - 15% and 20% maximum tax rates for individuals
- Undistributed Net Capital Gain

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TAX TREATMENT OF SHAREHOLDERS
(CONTINUED)

- Exempt-Interest Dividends
  - 50% diversification requirement
- Interest-Related Dividends (“qualified net interest income”) and Short-Term Capital Gain Dividends
  - Foreign shareholders
  - Exempt from withholding tax
- Pass-through of Foreign Taxes Paid

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TAX TREATMENT OF SHAREHOLDERS
(CONTINUED)

- Disposition of Shares
  - Taxable gain or loss – redemption, sale, or exchange
    - 15% and 20% maximum tax rates for individuals
  - Disposition of shares within 90 days
    - Limited to acquisitions by following January 31, by RIC Modernization Act
  - "Wash" sales
  - Sales after short holding period
  - Basis election/reporting
- 3.8% tax on "net investment income"

TAX TREATMENT OF SHAREHOLDERS
(CONTINUED)

- Disposition of Money Market Fund (“MMF”) Shares
  - Stable NAV – no taxable gain or loss
  - SEC rules – institutional non-government MMFs must price shares using market values – “floating NAV”
    - Dispositions could result in taxable gain or loss
  - Prompt Treasury/IRS response
    - New revenue procedure - “wash” sales rules will not apply
    - Proposed regulations – “NAV method” permits aggregating gain/loss during a “computation period” (taxable year or shorter period)
    - Proposed regulations – Form 1099 information reporting not required for disposed shares

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INCOME TAX TREATMENT OF A RIC

- Investment Company Taxable Income – taxable income with adjustments
  - Net capital gain excluded
  - No net operating loss or certain other deductions
  - Dividends-paid deduction
    - Dividends paid during the taxable year
    - Year-end Dividend Rule
    - “Spillover dividends”

EXCISE TAX ON UNDISTRIBUTED INCOME AND GAINS

- 4% Tax
  - Measured by calendar year, not taxable year
  - 98% of ordinary income
  - 98.2% of capital gain net income
    - 98% before RIC Modernization Act
  - 100% of “prior year shortfall”
  - Include dividends deemed paid under Year-end Dividend Rule but not spillover dividends

MASTER-FEEDER STRUCTURE

- RICs and other “institutional investors” invest (as “feeder funds”) in a “master fund”
  - Non-corporate registered management company
  - Partnership classification – “check-the-box”
  - Publicly traded partnership
    - Not registered under Securities Act of 1933, as amended
    - Private placement safe harbor

MULTIPLE CLASS ARRANGEMENTS

- Preferential Dividend Rule
  - Within class or between classes
  - Hundreds of PLRs
  - Revenue Procedures 96-47 and 99-40
  - RIC Modernization Act – inapplicable to “publicly offered RICs”
  - Waivers and reimbursements

FUND OF FUNDS

- Reimbursement of Upper-Tier Fund of Funds' Expenses
  - General principle – corporation's payment of shareholder's expense is constructive dividend
  - PLRs – not a preferential dividend
- Before RIC Modernization Act, couldn't use for RICs that wanted to pay exempt-interest dividends or to pass through foreign taxes; now "qualified funds of funds" may do so

RECENT ADDITIONAL MMF GUIDANCE

- Notice 2016-32
  - Insurance company separate (“segregated asset”) accounts must be “adequately diversified”
    - Can be satisfied by investing in “insurance-dedicated” RICs
  - Notice provides that an account is adequately diversified if either (1) the account itself is a government MMF or (2) the account invests all of its assets in an insurance-dedicated RIC that qualifies as a government MMF, but only if the account invests <u>all</u> of its assets in that RIC or another “look-through” vehicle.

RECENT ADDITIONAL MMF GUIDANCE
(continued)

- Revenue Procedure 2016-31
  - Certain MMFs have received “top up” contributions from their advisors to enable the initial floating NAV to match the stable NAV immediately before
  - Rev. Proc. permits an MMF to exclude a top up contribution from its investment company taxable income for purposes of the Distribution Requirement
  - MMF nevertheless must pay federal income tax on the contribution
  - Limited relief

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