K&L GATES

FEDERAL TAX ASPECTS

I. REQUIREMENTS FOR REGULATED INVESTMENT COMPANY TREATMENT

A regulated investment company ("**RIC**") — whether open-end or closed-end, and including an exchange-traded fund ("**ETF**") that is not a "grantor trust" or partnership — receives special treatment under Part I of Subchapter M of Chapter 1 of Subtitle A of the Internal Revenue Code of 1986, as amended ("**Subchapter M**") ("**Code**").[1] A RIC can completely eliminate corporate tax liability (and thus achieve so-called "**pass-through**" treatment). To qualify for that treatment, a fund must satisfy the specific requirements outlined below. Because each fund in a series investment company is treated as a separate corporation for federal tax purposes, those requirements apply to each such fund separately (except for the registration requirement in I.A. below, which the investment company satisfies). Thus, a RIC (*i.e.*, a *regulated* investment company) is not necessarily the same as a *registered* investment company.

A. **Domestic Corporation Registered under the 1940 Act**. To qualify as a RIC, a fund must, among other things, be a domestic corporation. This requirement is satisfied if the fund is (1) organized under a federal or state corporation statute (Maryland being the most popular state because of favorable provisions of its corporate law) or (2) a Delaware statutory trust, Massachusetts business trust, or other entity that, for federal tax purposes, either (a) elects to be classified as a corporation under the so-called "check-the-box" Regulations[2] or (b) is a "publicly traded partnership" (see I.C. below) that is treated as a corporation (cf. V.A.2. below).[3] A fund (or the company of which it is a series) must (x) be registered as a management company under the Investment Company Act of 1940, as amended ("**1940 Act**"), or (y) have in effect an election thereunder to be treated as a business development company, on every day of its taxable year. *See* section 851(a)(1)(A). Thus, a fund should file Form N-8A with the Securities and Exchange Commission ("**SEC**") when it is organized and not wait until it commences operations.

B. **Election to Be a RIC**. A fund must elect to be a RIC for its current taxable year or must have made that election in a previous taxable year. *See* section 851(b)(1). The election is made simply by filing a federal income tax return on Form 1120-RIC.

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1 "**Section**" references are to the Code, unless otherwise noted, and "**Treas. Reg. §**" references are to the final, temporary, and proposed regulations under the Code ("**Regulations**").

2 Treas. Reg. § 301.7701-3(c).

3 *See* section 7704.

C. **<u>Gross Income Requirement</u>**. A fund must derive at least 90% of its gross income each taxable year from (1) dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of securities or foreign currencies, or other income (including gains from options, futures, or forward contracts) derived with respect to its business of investing in securities or those currencies, and (2) net income derived from an interest in a "qualified publicly traded partnership" ("**QPTP**") ("**Income Requirement**"). *See* section 851(b)(2).[4]

<u>Income from Commodities</u>. Income from direct investments in commodities and from certain types of derivative contracts regarding commodities, such as certain swaps on commodity indices, is not qualifying income for the purpose of this requirement (in the case of those contracts, because, in the view of the Internal Revenue Service ("**Service**"), they are not securities). *See* Rev. Rul. 2006-1, 2006-1 C.B. 261, modified by Rev. Rul. 2006-31, 2006-1 C.B. 1133. (That conclusion, however, does not apply to commodities derivatives entered into "to reduce or hedge the level of risk in a [RIC-permitted] business." *See, e.g.*, private letter rulings ("**PLRs**") 200440012 (May 17, 2004) (options and futures on gold entered into to hedge long positions in shares of issuers engaged in gold mining, processing, refining, selling, etc.) and 201319003 (Jan. 30, 2013) (futures contracts on VIX, a volatility index).[5])

Shortly after publication of Rev. Rul. 2006-1, however, the Service began issuing PLRs holding that (1) income and gain from certain "structured notes that create a commodity exposure" (so-called "commodities-linked notes") constitute qualifying income and/or (2) amounts a RIC (constructively) must include in gross income from a wholly owned foreign subsidiary (a "controlled foreign corporation" ("**CFC**")) that invests in commodities and financial derivatives (even derivatives similar

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[4] A QPTP is defined as a publicly traded partnership — generally, a partnership the interests in which are "traded on an established securities market" or are "readily tradable on a secondary market (or the substantial equivalent thereof)" — other than a partnership at least 90% of the gross income of which consists of qualifying income described in clause (1) above.

[5] Although, under section 6110(k)(3), a PLR may not be cited as precedent, PLRs nonetheless "reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws." *Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962). Furthermore, PLRs may be helpful in establishing consistency of administrative treatment, and tax practitioners look to PLRs as generally indicative of the Service's views on the proper interpretation of the Code and the regulations thereunder. *Cf. Rowan Companies, Inc. v. United States*, 452 U.S. 247, 261 n. 17 (1981); *Buckeye Power, Inc. v. United States*, 38 Fed. Cl. 283, 285 (Claims Ct. 1997); *also see* Treas. Reg. § 1.6662-4(d)(3)(iii) (providing that PLRs issued after October 31, 1976, are authority for purposes of determining whether there is or was substantial authority for the tax treatment of an item under section 6662(d)(2)(B)(i), in connection with the imposition of the accuracy-related penalty under section 6662 to a substantial understatement of income tax).

to those that were the subject of the revenue rulings) (*see* PLR 201206015 (June 13, 2006, released Feb. 10, 2012 (not a typo))) also constitute qualifying income. The Service issued more than seventy of those PLRs thereafter, the most recent being PLR 201134014 (May 13, 2011) and 201135001 (May 23, 2011). In July 2011, however, the Service "temporarily" suspended the issuance of those PLRs pending its "re-examination" of the policies underlying them.

RICs' investments in CFCs for purposes of indirectly investing in commodities have become endangered as a result of proposed regulations published on September 28, 2016 ("**Proposed Regulations**"). Under the Proposed Regulations, a RIC's inclusions of a CFC's income — as well as income of a passive foreign investment company that is a "qualified electing fund" ("**QEF**") — will no longer be considered qualifying income for the RIC, and only *distributions* the CFC or QEF makes to the RIC out of its associated earnings and profits for the applicable taxable year (as expressly provided in section 851(b)) will qualify. Although many RICs currently do receive annual distributions from their wholly owned CFCs, RICs that do not — and RICs that have investments in QEFs (which generally do not make annual distributions) — might have difficulty in one or more taxable years satisfying the Income Requirement.

Contemporaneously with publication of the Proposed Regulations, the Service issued Rev. Proc. 2016-50, 2016-43 I.R.B. 522, which provides that the Service will not ordinarily issue PLRs on any issue relating to the treatment of a corporation as a RIC that requires a determination of whether a financial instrument or position is a "security."[6] Accordingly, the Service subsequently revoked the parts of previously issued PLRs regarding commodity-linked notes, and future PLRs addressing the status of those notes will be rarely issued, if at all.

Although the "Regulated Investment Company Modernization Act of 2010," as passed by the House of Representatives on September 28, 2010, included a provision that would have treated all income from commodities as qualifying income, that provision was eliminated from the bill as passed by the Senate and enacted on December 22, 2010 ("**RIC Mod Act**").

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[6] *See* section 4.01(63) of Rev. Proc. 2018-3, 2018-1 I.R.B. 130 (the revenue procedure annually issued regarding domestic "no rule" areas). Note that section 4 of that annual revenue procedure lists "Areas in Which Rulings … Will not Ordinarily Be Issued, as compared to section 3 thereof, the title of which omits "Ordinarily."

D. Diversification Requirements

1. 50% of Assets

At the close of each quarter of a fund's taxable year, at least 50% of the value of its total assets must be invested in cash, cash items (including receivables), Government securities, securities of other RICs, and (subject to the 5% and 10% restrictions noted in a) and b) below) other securities. *See* section 851(b)(3)(A). Compare the diversification requirement in section 5(b)(1) of the 1940 Act (at least 75% of assets must be so diversified *at all times*). The other 50% of a fund's assets may be invested in anything, subject to the 25% diversification requirement described in D.2. below, although that may not satisfy the 1940 Act diversification requirement.

a) *5% of assets in a single issuer*. If more than 5% of the value of a fund's total assets is invested in the securities of a single issuer, *all* those securities (not merely the excess over 5%) do not qualify for the purpose of the 50%-of-assets requirement.

b) *10% of a single issuer's voting securities*. If a fund owns more than 10% of the voting securities of a single issuer — equity securities of QPTPs are considered voting securities for this purpose — none of those securities qualifies.

c) *Treatment of Specific Instruments*

(1) Certificates of Deposit. The Service has ruled that short-term CDs are cash items, not securities (though the SEC has classified them as securities).

(2) Bankers' Acceptances. The Service has ruled that these are not cash items for a real estate investment trust (which is governed by similar rules in Part II of Subchapter M). Presumably, the same treatment applies to RICs.

(3) Repurchase Agreements. Pursuant to Rev. Proc. 2004-28, 2004-1 C.B. 984, a fund may treat a position in a repo that is "collateralized fully" with Government securities as such securities (*i.e.*, "good" assets) for diversification purposes. Previously, a repo was treated for those purposes as a secured loan (*i.e.*, a single security issued by the counterparty ("borrower")), not a purchase and resale of the underlying securities; and a repo will continue to be so

treated if it fails to satisfy the revenue procedure's requirements. Moreover, the revenue procedure does not apply for purposes of the diversification requirement under section 817 that applies to separate accounts on which variable annuity and life insurance products are based.

(4) Overnight loans of federal funds are not cash, but securities.

(5) Government Securities. There is no definition of "Government securities" in the Code or the Regulations. However, for purposes of the diversification requirements, the Code adopts the definitions in the 1940 Act for any term not defined in the Code. *See* section 851(c)(6). Section 2(a)(16) of the 1940 Act defines a "government security" as any security issued or guaranteed as to principal or interest by the United States or by a person controlled or supervised by, and acting as an instrumentality of, the U.S. government pursuant to authority granted by Congress. Thus, for example, Government National Mortgage Association (a/k/a "Ginnie Mae"), Federal National Mortgage Association (a/k/a "Fannie Mae"), and Federal Home Loan Mortgage Association (a/k/a "Freddie Mac") mortgage-backed and mortgage participation certificates are Government securities. *See* Rev. Rul. 92-89, 1992-2 C.B. 154, for a short list of other Government securities; also *see* Rev. Rul. 2003-84, 2003-2 C.B. 289 (refunded municipal bonds, with respect to which Government securities are placed in escrow to fund future payments on the bonds, are Government securities for purposes of the diversification requirements). Options, futures, and options on futures on Government securities also appear to be Government securities.

2. 25% of Assets

At the close of each quarter of a fund's taxable year, not more than 25% of the value of its total assets may be invested in (a) securities (other than Government securities or securities of other RICs) of any one issuer, (b) securities (excluding other RICs' securities) of two or more issuers the fund controls that are determined to be engaged in the same, similar, or related trades or businesses, or (c) securities of QPTPs. *See* section 851(b)(3)(B).

3. No Disqualification for Certain Failures to Comply (Section 851(d))

a) *Market Fluctuation Exception*. If a fund fails to meet a diversification requirement due solely to market fluctuations, distributions, or redemptions, rather than wholly or partly because of an acquisition, the fund will not be disqualified if it had satisfied both diversification requirements at the close of the first quarter of the first taxable year for which it elected to be a RIC.

Example - A fund acquired a position in an issuer's securities valued at that time at less than 25% of the fund's total assets. If that position subsequently exceeded 25% of those assets at a quarter-end because those securities increased in value more rapidly than the fund's other assets or because the fund had to liquidate other securities to make one or more cash distributions, the failure to satisfy the 25% diversification requirement would not disqualify the fund. But if it then acquired (including through a transfer in connection with a reorganization) as little as one additional share of that issuer's securities (even if its cost plus the cost of the original shares still was less than 25% of the fund's total asset value), the fund would no longer be able to rely on this exception.

b) *30-Day Cure Period*. If a fund's failure to satisfy a diversification requirement at the close of any quarter is wholly *or partly* (see example above) the result of an acquisition (including, in the case of a closed-end fund, a redemption or repurchase of its own securities!), the fund has 30 days after the close of the quarter in which to cure the failure.

c) The RIC Mod Act enacted provisions that enable a fund to preserve its RIC status in the case of a failure "due to reasonable cause and not due to willful neglect" ("inadvertent failure") or a *de minimis* failure to meet the diversification requirements, as well as an inadvertent failure to meet the Income Requirement, by making certain disclosures and paying a specially calculated tax.

E. Distribution Requirement

A fund that satisfies all the above requirements qualifies *to be* a RIC. To qualify for the pass-through treatment of Subchapter M, however, a RIC also must distribute to its shareholders for each taxable year at least 90% of the sum of its "**investment company taxable income**" — which generally consists of (1) net investment income, (2) the excess of net short-term capital gain (essentially, net gain from the sale or exchange of capital assets held for one year or less) over net long-term (more than one year) capital loss ("**short-term capital gain**"), and (3) net gains and losses from certain foreign currency transactions, all determined without regard to the dividends-paid deduction (see III. below) — plus its net interest income excludable from gross income under section 103(a) ("**Distribution Requirement**"). *See* section 852(a)(1).[7] There is no requirement to distribute any "**net capital gain**" (*i.e.*, the excess of net long-term capital gain over net short-term capital loss). For these and other purposes (see, *e.g.*, II.A.-E. and III. below), dividends and other distributions that (1) a RIC declares in the last quarter of any calendar year, (2) are payable to shareholders of record on a date in that quarter, and (3) are actually paid during the following January are deemed to have been paid by the RIC and received by the shareholders on December 31 of that year ("**Year-end Dividend Rule**"). *See* section 852(b)(7).

II. <u>TAX TREATMENT OF SHAREHOLDERS</u>

A. **<u>Income Dividends</u>**. A RIC's distributions to its shareholders from its investment company taxable income (including short-term capital gain) are taxed to them, unless they are exempt from federal income tax, as ordinary income. *See* section 301(c)(1). A portion of those dividends, however, may be subject to federal income tax for individual and certain other non-corporate shareholders (each, an "individual shareholder") at the lower rates for net capital gain — a maximum of 15% for a single shareholder with taxable income not exceeding $425,800 ($479,000 for married shareholders filing jointly and $452,400 for a head of household) and 20% for individual shareholders with taxable income exceeding those respective amounts (which apply for 2018 and will be adjusted for inflation annually thereafter[8]) ("**Maximum Tax Rates**"). *See* section 1(h)(11). The portion of a RIC's dividends subject to those rates ("**qualified dividend income**" or "**QDI**") may not exceed the aggregate dividends the RIC receives from most domestic corporations and certain foreign corporations (subject to its satisfying certain holding period and other restrictions with respect to the stock on which the dividends are paid), unless that aggregate is at least 95% of its gross income (as specially computed), in which case the entire dividend qualifies. In addition, the Maximum Tax Rates apply to a shareholder only if he or she satisfies the same restrictions with respect to the RIC shares on which the dividends are paid.

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[7] Technically, to qualify for that treatment a RIC's dividends-paid deduction (see III. below) must be at least 90% of that sum, and not all distributions qualify for that deduction. *See, e.g.*, the "preferential dividend" rule described in V.B. below.

[8] Those amounts will be $418,400 and $470,700, respectively, for 2017.

A portion of a RIC's dividends also may be eligible for the dividends-received deduction allowed to corporations ("**DRD**"), subject to similar restrictions. The eligible portion may not exceed the aggregate dividends the RIC receives from domestic corporations subject to federal income tax (excluding real estate investment trusts) and, unlike QDI, excludes dividends from foreign corporations. *See* section 854(b). Before the effective date of the major tax law passed last year (see VI. below), dividends a corporate shareholder deducted pursuant to the DRD were subject indirectly to the federal alternative minimum tax.

B. **Net Capital Gain**. A RIC's distributions to its shareholders from its net capital gain, when reported as such in writing to its shareholders, are treated by them as long-term capital gain. *See* section 852(b)(3)(B). (The RIC Mod Act eliminated a requirement that capital gain dividends and certain other dividends be properly "designated" for tax purposes, which normally was accomplished in a RIC's annual report to its shareholders.) Similar treatment is provided for undistributed net capital gain. *See* section 852(b)(3)(D). Any distributions a RIC makes of net capital gain it recognizes are subject to the Maximum Tax Rates for individual shareholders. *See* section 1(h)(11). Note that this treatment is determined by how long the RIC held the investments the sale of which generated the gain, not by how long a shareholder held the RIC's shares.

C. **Exempt-Interest Dividends**. If at least 50% of the value of a RIC's total assets at the close of each quarter of its taxable year consists of obligations the interest on which is excludable from gross income under section 103(a),[9] then the RIC's distributions of the excess of that interest income over certain amounts disallowed as deductions, when reported as such in writing to its shareholders ("**exempt-interest dividends**"), may be excluded from gross income by its shareholders. *See* section 852(b)(5).

D. **Interest-Related and Short-Term Capital Gain Dividends**. The income dividends a RIC pays to a non-U.S. shareholder from its investment company taxable income (which, as noted in I.E. and II.A. above, includes short-term capital gain) generally are subject to a 30% (or lower treaty rate) federal withholding tax. That tax does not apply, however, to a RIC's "interest-related dividends" (*i.e.*, distributions of its "qualified net interest income," which is "qualified interest income" less allocable deductions, from sources within the United States) and "short-term capital gain dividends" (essentially, distributions of its short-term capital gain, subject to certain adjustments), reported as such in writing to its shareholders, that are paid to a shareholder who filed a statement

9 The Service took the position in a 1978 PLR (and continues to adhere thereto) that shares in other RICs that satisfy this requirement do not count toward the shareholder RIC's satisfying it (*i.e.*, no "look-through") (but see V.C.3. below).

(presumably a Form W-8BEN) that the beneficial owner of the RIC's shares was a non-U.S. person, with certain exceptions. *See* sections 871(k), 881(e), 1441(c)(12), and 1442(a).

E. **<u>Foreign Taxes</u>**. If more than 50% of the value of a RIC's total assets at the close of any taxable year consists of securities of foreign corporations, the RIC may elect to pass-through to its shareholders any foreign withholding, income, and similar taxes it pays, with respect to which the shareholders may be able to claim a foreign tax credit or deduction on their own income tax returns. *See* section 853. Generally, this pass-through treatment will be available only to funds that invest primarily in foreign securities. But see V.C.3. below.

F. **<u>Disposition of Shares</u>**

1. **<u>Taxable Gain or Loss</u>**. When a shareholder redeems an open-end RIC's shares or sells a closed-end fund's or ETF's shares on an exchange, the shareholder will recognize taxable gain or loss, measured by the difference between the redemption/sale proceeds and the shareholder's adjusted basis in the redeemed/sold shares (or, in the case of an ETF that is treated for federal tax purposes as a "grantor trust," the shareholder's share of the ETF's underlying assets), which normally includes any sales charge paid on them. An exchange of RIC shares for shares of another RIC (usually permitted within fund complexes without payment of sales charges) — not to be confused with conversion of shares from one class of a RIC to shares of another class of the same RIC (which generally is not a taxable event) — normally will have similar tax consequences. Any capital gain an individual shareholder recognizes on a redemption or exchange of shares that have been held for more than one year will qualify for the Maximum Tax Rates. The legislation that enacted those rates did not change the tax rate on short-term capital gain, which continues to be taxed at the ordinary income rate.

2. **<u>Disposition of Certain Shares</u>**. If a shareholder disposes of a RIC's shares ("original shares") within 90 days after purchase thereof and, by January 31 following the year of the disposition, reacquires shares of that RIC or acquires shares of another RIC on which a sales charge normally is imposed ("replacement shares"), in either case without paying the sales charge (or paying a reduced charge) due to an exchange privilege or a reinstatement privilege, then (a) any gain on the disposition of the original shares will be increased, or any loss thereon decreased, by the amount of the sales charge paid when those shares were acquired (in effect, excluding that amount from the basis in the original shares) and (b) that amount will increase the adjusted basis in the replacement shares that were subsequently acquired. *See* section 852(f).

3. **<u>“Wash” Sales</u>**. If a shareholder purchases shares of a RIC (whether pursuant to a reinstatement privilege or otherwise) within 30 days before or after redeeming other shares of that RIC (regardless of class) at a loss, all or part of that loss will not be deductible and instead will increase the basis in the newly purchased shares.

4. **<u>Sales after Short Holding Period</u>**. If a shareholder disposes of RIC shares at a loss within six months after purchasing them, (a) the loss will be disallowed to the extent of any exempt-interest dividends received on the shares and (b) any loss that is not disallowed will be treated as long-term, rather than short-term, capital loss to the extent of any capital gain distributions received thereon. *See* section 852(b)(4). (The reference to six months here — previously the maximum holding period to which short-term capital gain treatment applied — is not a typo; the rule described in this paragraph just wasn't changed when that holding period was extended to a year.)

G. **<u>Basis Election/Reporting</u>**. A shareholder who wants to use the average method for determining basis with respect to RIC shares he or she acquired or acquires after December 31, 2011 (“**Covered Shares**”), must elect to do so in writing (which may be electronic). If a shareholder of a RIC fails to affirmatively elect the average basis method, then basis determination will be made in accordance with the RIC's default method, which might be a method other than average basis. If, however, a RIC's default method is average basis and a shareholder wishes to use a different acceptable method for basis determination (*e.g.*, a specific identification method), the shareholder may elect to do so. The basis determination method a shareholder elects may not be changed with respect to a redemption of Covered Shares after the settlement date of the redemption.

In addition to the requirement to report the gross proceeds from the redemption of shares, a RIC (or its administrative agent) must report to the Service and furnish to its shareholders the basis information for Covered Shares and indicate whether they had a short-term or long-term holding period.

H. **<u>Tax on “Net Investment Income</u>**.” An individual is required to pay a 3.8% federal tax on the lesser of (1) the individual's “net investment income,” which generally includes taxable dividends, interest, and net gains from the disposition of investment property (including taxable dividends and capital gain distributions a RIC pays and net gains realized on the redemption or exchange of RIC shares), or (2) the excess of the individual's “modified adjusted gross income” over a threshold amount ($250,000 for married persons filing jointly and $200,000 for single taxpayers, which amounts, unlike the thresholds for QDI, are not indexed for inflation). This tax is in addition to any other taxes due on that income. A similar tax applies to estates and trusts.

I. **<u>Disposition of Certain Money Market Fund ("MMF") Shares</u>**. A redemption of shares of an MMF that maintains a stable net asset value per share ("**NAV**"), usually $1.00, will not result in recognition of any gain or loss. In 2014, however, the SEC adopted new rules governing MMFs, the principal change, for tax purposes, requiring institutional (*i.e.*, non-retail) non-"government" MMFs (including institutional tax-exempt MMFs) to price their shares using portfolio securities' market values (rather than the previously permitted amortized cost and/or penny rounding methods, which produced stable values) and to calculate their NAVs to the nearest 1% or four decimal points. Those MMFs' NAVs thus are expected to "float," so each redemption of shares of such an MMF (a "**Floating-NAV MMF**") could result in taxable gain or loss, in the latter case potentially implicating the "wash" sale rules described in II.F.3. above.

The Treasury Department and the Service promptly issued taxpayer-friendly guidance to deal with that change. Rev. Proc. 2014-45, 2014-34 I.R.B. 388, provides that a taxpayer may recognize loss on the sale of Floating-NAV MMF shares even if the taxpayer purchases shares in the same fund within the 30-day wash sale period. (Those purchases are quite common, particularly if a shareholder reinvests dividends.) The Service justified this approach on the understanding that Floating-NAV MMFs' share prices will be relatively stable and that monitoring Floating-NAV MMF transactions for wash sales would be unreasonably burdensome for taxpayers.

The following two sets of proposed regulations also were published:

(1) Under the proposed "NAV method," a taxpayer generally would be permitted to calculate gain or loss based on the change in the aggregate value of its Floating-NAV MMF shares and net purchases/redemptions during a "computation period" — which may be the taxpayer's taxable year or a shorter period, but all computation periods must be approximately equal in length — thus greatly simplifying the calculation of gain and loss realized on Floating-NAV MMF share redemptions. Any net capital gain or loss would be treated as short-term. If a taxpayer elects to use the NAV method, it must be applied to all Floating-NAV MMF shares it owns; and

(2) The existing exemption from Form 1099 information-reporting requirements for MMFs would be extended to cover Floating-NAV MMFs as well; many shareholders of Floating-NAV MMFs (including corporations, tax-exempt entities such as pension funds and individual retirement accounts, governmental entities, financial institutions, and other RICs) would not receive Forms 1099 anyway because they are "exempt recipients" under existing regulations. The proposed regulations may be relied on before they are finalized.

The proposed regulations were finalized in T.D. 9774 (July 7, 2016) with minimal changes regarding use of the NAV method and none regarding the Form 1099 exemption. See V.D. below for additional federal tax guidance relating to the changed SEC MMF rules.

III. INCOME TAX TREATMENT OF A RIC

A RIC is taxed on its investment company taxable income (see I.E. above), which generally is taxable income determined in the same manner as a normal corporation, with three significant differences:

(a) net capital gain is excluded (and is taxed separately, except for gain that is distributed, or treated as distributed, to the RIC's shareholders);

(b) the net operating loss deduction and certain other deductions available to normal corporations are not allowed; and

(c) most importantly, the RIC is allowed a deduction for dividends it pays to its shareholders (unless the dividend is preferential (see V.B. below)).

See section 852(b)(2).

With respect to (c) above, the dividends-paid deduction for a taxable year applies not only to dividends paid during that year but also to dividends distributed in accordance with the Year-end Dividend Rule and to so-called "spillover" (or "spillback") dividends. The latter are dividends (1) declared by the 15th day of the 9th month after the end of a taxable year (or, if later, the extended due date for filing the RIC's tax return for that year), thus, in effect, giving RICs an automatic 5-month extension for these purposes,[10] and (2) distributed within the following taxable year not later than the date of the first regular dividend payment made after the declaration. Thus, if a RIC makes qualifying distributions to its shareholders of all its net ordinary income and net realized gains, it avoids the "double taxation" that applies to normal corporations and their shareholders and instead receives pass-through treatment. Note that although shareholders are deemed to have received distributions subject to the Year-end Dividend Rule on December 31 of the year in which they are declared, spillover dividends are taxable to shareholders in their taxable year in which they actually receive the dividends.

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[10] The deadline before the RIC Mod Act was the due date for filing the RIC's tax return -- which was changed, effective for taxable years beginning after Dec. 31, 2015, from the 15th day of the third month, to the 15th day of the fourth month, following the close of the corporation's taxable year -- including extensions (which, unfortunately, many RICs over the years inadvertently failed to timely apply for).

IV. EXCISE TAX

A RIC will be subject to a nondeductible 4% federal excise tax to the extent it fails to distribute by the end of any *calendar* year (not its *taxable* year) at least the sum of (1) 98% of its ordinary (not including tax-exempt) income for that year, (2) 98.2% (which was increased from 98% under the RIC Mod Act, to pay for the "tax benefits" thereunder) of its capital gain net income for the one-year period ending on October 31 of that year, plus (3) 100% of certain other amounts (known as the "prior year shortfall"). *See* section 4982(a). For these purposes, distributions for a calendar year include the deductible dividends paid (or deemed paid, pursuant to the Year-end Dividend Rule) by the RIC during that year and amounts on which the RIC pays tax for any taxable year ending in that calendar year (*see* section 4982(c)(1)) but do not include spillover dividends.

V. CERTAIN FUND STRUCTURES AND TYPES OF FUNDS

A. **Master-Feeder Structure**. One or more RICs, joined either by other "institutional investors" — such as common trust funds and commingled group trusts but excluding "insurance-dedicated RICs" (see V.D.1 below) — or by the RIC's investment adviser (if there is only one RIC), may invest (as "**feeders**") in another investment vehicle (a "**master fund**"). A RIC feeder generally invests "substantially all its investable assets" in the master fund.

1. **Partnership Classification**. A master fund is a Delaware statutory trust, Massachusetts business trust, New York common law trust (used in the Signature Financial Group's "Hub and Spoke"SM model, which pioneered the structure), or other non-corporate entity that is registered as a management company under the 1940 Act. It is critical that the master fund be classified for federal tax purposes as a partnership, which is not a taxpaying entity, because the "double taxation" resulting from classification as a corporation would far outweigh any benefits otherwise available from the master-feeder structure. Partnership classification can be assured by complying with the "check-the-box" Regulations (Treas. Reg. § 301.7701-3(c)), which is relatively easy to accomplish. (Compare I.A.(2))

2. **Publicly Traded Partnership**. Partnership classification is not enough, however, because a publicly traded partnership generally is treated as a corporation for federal tax purposes and thus leads to double taxation. To avoid classification as a publicly traded partnership, the offering of interests in the master fund must not be registered under the Securities Act of 1933, as amended ("**1933 Act**") (to take advantage of the "private placement safe harbor" provided in the Regulations under section 7704).

B. **Multiple Class Structure**. Before the RIC Mod Act, no dividends-paid deduction was available for a distribution (and, therefore, no pass-through treatment for the distributing RIC unless other deductible distributions satisfied the Distribution Requirement) unless it was *pro rata*, with no preference to any share as compared with other shares of the same class, and with no preference to one class as compared with another class except to the extent the former was entitled (without reference to waivers of their rights by shareholders) to that preference (the so-called "preferential dividend" rule). *See* section 562(c). The Service refused to recognize multiple-class structures of the type adopted by RICs (*i.e.*, those based largely on differences in 12b-1 fees, shareholder services, and sales charges) as creating separate "classes" for these purposes. But hundreds of PLRs issued in the early 1990s and two revenue procedures the Service issued later in that decade (Rev. Proc. 96-47, 1996-2 C.B. 338, and Rev. Proc. 99-40, 1999-2 C.B. 565) enabled multiple-class RICs to have classes with different 12b-1 fees and certain other "class-specific" expenses, as well as waivers and reimbursements of advisory fess and certain other such expenses, without violating the preferential dividend rule. Significantly, the RIC Mod Act made this rule inapplicable to "publicly offered" RICs,[11] though it still applies to other RICs.

C. **Fund of Funds Structure**. This structure involves a RIC that invests in one or more underlying RICs (and, possibly, other types of investments, such as non-RIC ETFs).

1. **Reimbursement of Expenses**. In a 1990 PLR, the Service ruled that reimbursements of expenses by an underlying RIC to an upper-tier fund of funds did not result in preferential dividends. The Service reached this conclusion notwithstanding the general principle of federal income taxation that the payment by a corporation (*e.g.*, an underlying RIC) of a shareholder's (*e.g.*, a fund of fund's) expenses is a constructive dividend to that shareholder, which in the fund context would result in a preferential dividend paid by an underlying RIC to its shareholder, the fund of funds. Thereafter, the Service issued many favorable PLRs on this structure.

2. **Limitations**. Until enactment of the RIC Mod Act, a fund of funds structure generally could not be used successfully for a tiered structure of RICs that wanted to pay exempt-interest dividends or pass through to their shareholders the foreign tax credit or deduction (see II.C. and II.E, respectively, above). This was so because of the special diversification

[11] For these purposes, a "publicly offered RIC" is one "the shares of which are (I) continuously offered pursuant to a public offering (within the meaning of section 4 of the [1933 Act]), (II) regularly traded on an established securities market, or (III) held by or for no fewer than 500 persons at all times during the taxable year." Section 67(c)(2)(B).

requirement that applies to each: (1) for a municipal bond fund, the requirement that at least 50% of the value of its total assets at the close of each quarter of its taxable year consist of obligations the interest on which is excludable from gross income under section 103(a) (and other RICs' shares are not those obligations); and (2) for an international fund, the requirement that more than 50% of the value of its total assets at the close of any taxable year consist of securities of foreign corporations (and other RICs' shares are not those securities).

3. **RIC Mod Act**. Pursuant to the RIC Mod Act, an upper-tier RIC that invests, at the end of each quarter of its taxable year, at least 50% of the total value of its assets in other RICs (a "qualified fund of funds") may pass through the exempt-interest dividends and foreign tax credit/deduction it receives from those other RICs.

D. Money Market Funds. As noted above (see II.I.), in 2014 the SEC adopted amendments that introduced the requirement for MMFs other than government MMFs and retail funds to price their shares using a "floating" NAV, and the Treasury Department and the Service acted promptly to deal with certain tax aspects of those amendments. The Service has taken additional steps to alleviate some of the unintended tax consequences caused by those amendments.

1. **Notice 2016-32** (jointly issued with the Treasury Department) ("**Notice**"). The Notice (2016-21 I.R.B. 878) is designed to fix a potential problem for insurance-dedicated RICs — *i.e.*, RICs that are investment vehicles for insurance company separate accounts (referred to as "segregated assets accounts" in the federal tax law) on which variable annuity and life insurance products are based) (each, an "**Account**") — that invest in stable-NAV government MMFs. An Account must meet an asset diversification requirement under section 817(h) (it must be "adequately diversified"); one way it can do that is by investing in an insurance-dedicated RIC that has an investment portfolio meeting the requirement. The Notice provides an alternative diversification requirement so that an Account that solely invests in an insurance-dedicated government MMF can meet the section 817(h) diversification requirement. Broadly stated, an Account is adequately diversified under the alternative 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 *all* of its assets in the insurance-dedicated RIC or another "look-through" vehicle.

2. **Revenue Procedure 2016-31**. This revenue procedure (2016-21 I.R.B. 988) provided temporary relief (see below) for certain MMFs that received so-called "top up" contributions from their advisers as the funds

transitioned to comply with the new share pricing rules (*i.e.*, contributions so that the initial floating NAV of the shares would match the stable NAV that existed immediately before the transition) ("**Revenue Procedure**"). The Revenue Procedure permits an MMF to exclude a top up contribution from its investment company taxable income for purposes of the Distribution Requirement, but the MMF nevertheless must pay federal income tax on that amount. As a result of tax having been paid thereon, the top up contribution would be deemed to have been distributed for purposes of determining the MMF's liability for the 4% excise tax on under-distributions (see IV. above). This relief only applied to contributions made in connection with the transition of certain MMFs to a floating NAV before the October 14, 2016, compliance deadline for making that transition.

VI. TAX CUTS AND JOBS ACT ("Act")

A. **20% Deduction**. The Act provides a 20% deduction for "qualified business income," including "qualified publicly traded partnership income" ("**QPTPI**") and "qualified real estate investment trust ["**REIT**"] dividends. However, unlike the pass-throughs of QDI, the DRD, capital gain, exempt-interest, interest-related, and short-term capital gain dividends, and foreign taxes (see II. A.-E., above), the Act does not provide for a RIC to pass through QPTPI and qualified REIT dividends to its shareholders. Although that omission may have been an oversight, attempts to persuade the Service to correct it thus far have been met with resistance, based on the fact that all the other pass-throughs are set forth in the Code. Prospectus or SAI disclosure of a RIC's inability to pass-through the elements of the 20% deduction to its shareholders, who would be eligible for the deduction by direct investment, is recommended.

B. **Limitation on business interest deduction**. The deduction for "business interest" of a corporation — as noted above, a RIC is treated as a corporation under the Code — and other entities that engage in a trade or business in which many RICs invest is limited for any taxable year beginning after December 31, 2017. The deduction generally is limited to the sum of a taxpayer's "business interest income" (which expressly excludes "investment interest income") plus 30% of its "adjusted taxable income" — which is defined to mean taxable income without regard to, among other things, any deduction "not properly allocable to a trade or business" — for the year. Nondeductible business interest expense generally may be carried forward indefinitely, except in the case of partnerships, which are subject to certain additional special rules. Although this limitation, as written, applies to RICs, as corporations, *it may be possible that future guidance will (1) exclude RICs,* as "investment" companies and thus not "engaged in a trade or business," *from application thereof and/or (2) permit a RIC to not have to take* *into account in determining its adjusted taxable income the dividends-paid deduction* (which enables a RIC to fully offset its taxable income and net capital gain) because it is a deduction "not properly allocable to [its] trade or business."

C. **Repatriation of deferred foreign income**. Prior to the Act, U.S. corporations, U.S. citizens, and resident individuals were taxed on their worldwide income. An extremely complicated provision in the Act (adding section 965 to the Code) is designed to deal with the transition to a "participation exemption system of taxation." Very briefly, it provides that a U.S. shareholder, including a RIC, that owns 10% or more of a foreign corporation generally must include in the shareholder's gross income (for its taxable year in which or with which the foreign corporation's last taxable year that began before 2018 ends ("last year")) the shareholder's *pro rata* share of the foreign corporation's earnings and profits ("**E&P**") for the last year accumulated after December 31, 1986, to the extent the E&P have not previously been subject to federal income tax; the Act also provides a complex formula for a deduction related to that inclusion. While the Act provides that (1) such deemed income inclusion will not be taken into account for purposes of the REIT qualifying income requirement (which, like many other REIT qualification requirements, is similar to the Income Requirement applicable to RICs (see I.C. above)) and (2) a REIT may elect to spread that income inclusion over eight annual installments, it did not address these matters with respect to RICs; and regulations proposed August 9th of this year expressly declined to adopt a suggestion from the Investment Company Institute to extend the election to RICs "because the statute provides the election solely for REITs."