REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2009

On December 16, 2009, Chairman Charles B. Rangel of the House Ways and Means Committee introduced H.R. 4337, the Regulated Investment Company Modernization Act of 2009 (the "Act"), which would revise several important tax compliance rules for mutual funds taxed as regulated investment companies ("RICs").

Commodities and Currency Gains as RIC Qualifying Income. The Act would expand the definition of RIC qualifying income so as to include gains from the sale or other disposition of commodities and other income related to a RIC's investing in commodities. The Act would also repeal the U.S. Department of Treasury's regulatory authority to limit the circumstances in which foreign currency gains constitute RIC qualifying income.

Preferential Dividends. The Act would repeal the preferential dividend rule for publicly offered RICs.

Capital Loss Carryforwards. The Act would eliminate the current eight year limit on the use of capital loss carryforwards. Also, under the Act, RIC capital losses may carry forward as either short-term losses or long-term losses.

Qualification Failures for Reasonable Cause. Under the Act, RICs would be allowed to cure a failure of the RIC qualifying income test by paying a tax equal to the amount of nonqualifying income in excess of 10 percent of the RIC's gross income. RICs would be allowed to cure *de minimis* asset diversification failures, defined as discrepancies of less than the lesser of one percent of total assets or $10 million, by disposing of the nonqualifying assets or otherwise meeting the asset qualification test within six months of the last day of the quarter of discovery. Discrepancies that exceed the *de minimis* threshold but that are due to reasonable cause and not willful neglect may also be cured by disposing of the assets or otherwise meeting the qualification test within the six-month period but subject to a penalty tax on the net income generated by these nonqualifying assets, with a minimum tax of $50,000. These new cure provisions would be effective for any taxable years for which an income tax return due date is after the date of enactment of the Act.

RIC Funds of Funds. The Act would provide that redemptions of open-end RIC shares made upon shareholder demand would be treated as exchanges in all cases and not as dividends. The Act would permit immediate recognition of losses on such redemptions by a RIC mostly invested in another open-end RIC. These provisions would apply to redemptions made after the date of enactment of the Act. The Act would also permit a RIC solely invested in other RICs to pass-through exempt-interest dividends as well as foreign tax credits.

Modifications to Distributions and Allocations. The Act would assist RICs in avoiding reallocations of return of capital distributions to prior calendar years. Similar rules would be included for over-reporting of long-term capital gain dividends, exempt-interest dividends, interest-related dividends and short-term capital gain dividends. RICs would no longer be subject to a 60-day notice requirement for designating the character of dividends and would be permitted to report capital gains dividends, exempt-interest dividends and other pass-through distributions to shareholders on Forms 1099 only.

Spillback Dividends. The Act would provide that a RIC may declare a spillback dividend, which is a dividend that relates to a prior year's income or gains, within nine and one-half months of the end of the prior year without needing to file a tax return extension for the prior year. Also, the RIC would only need to pay a declared spillback dividend before or with the payment of the next dividend of the same type, not any dividend as currently required.

Post-October Losses and Excise Tax Coordination. The Act would allow the deferral of post-December ordinary losses and of post-October net short-term losses, in addition to the currently recognized post-October net loss deferrals and net long-term loss deferrals. The Act would provide that ordinary income items subject to a year-end mark-to-market regime should be recognized using October 31 values for purposes of the RIC excise tax rules. The Act would allow RICs making estimated tax payments to claim the amounts to which such taxes relate as distributed in that calendar year. As variable insurance product funds are generally exempt from the excise tax rules, the Act would coordinate the list of acceptable shareholders for RICs exempt from excise tax rules with the list of acceptable shareholders under the variable insurance product rules. All of the above excise tax provisions would apply to calendar years beginning after the date of enactment.

Earnings and Profits of Tax-Exempt Bond Funds. The Act would provide that a tax-exempt bond fund's expenses and bond premium amortization reduce the fund's current earnings and profits.

Losses Due to Load Charges. Under current law, if RIC shares are sold within 90 days of the original purchase, shareholders cannot recognize a loss on the original shares attributable to the amount of the load charge if the load charge is waived on a future RIC investment, but they instead must reduce the basis of the original shares by the amount of the load charge and carry over the amount to increase the basis of the future investment. Under the Act, this rule would apply only if the future RIC investment occurs on or before January 31 of the calendar year following the year in which the original shares are sold. This provision would apply for taxable years beginning after date of enactment.

Repeal of Penalty on Deficiency Dividends. Under current law, a RIC that distributes a deficiency dividend must pay a penalty that can be as high as one-half of the amount of the dividend. The Act would repeal this penalty.

Effective Dates. Unless otherwise noted, all provisions would be effective for a RIC's first taxable year beginning after the Act's date of enactment.

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If you have any questions regarding this memorandum, please contact Joseph A. Riley (212-728-8715, jriley@willkie.com), or the attorney with whom you regularly work.

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