REGULATED INVESTMENT COMPANY MODERNIZATION ACT OF 2010
ENACTED INTO LAW

On December 22, 2010, President Obama signed into law the Regulated Investment Company Modernization Act of 2010 (the “Act”). The Act updates certain tax rules applicable to regulated investment companies (“RICs”), including open-end mutual funds and closed-end funds. Unless otherwise noted, all of the provisions below will be effective for a RIC’s first taxable year beginning after December 22, 2010.

The provisions of the Act are substantially similar to those introduced by the House Ways and Means Committee on December 16, 2009. However, provisions that would have allowed RICs to treat gains from commodities as “qualifying income” under the RIC tax compliance requirements were not included in the final version of the legislation.

**Preferential Dividends.** The Act repeals the preferential dividend rule for publicly offered RICs. However, the similar restrictions on expense allocations included in Rule 18f-3 of the Investment Company Act of 1940 remain in place.

**Capital Loss Carryforwards.** The Act eliminates the current eight-year limit on the use of capital loss carryforwards, effective for losses generated in the first taxable year after the date of enactment. Also, under the Act, RIC capital losses are to be carried forward as either short-term losses or long-term losses, as applicable.

**Qualification Failures for Reasonable Cause.** Under the Act, RICs may cure a failure of the RIC qualifying income test by paying a tax equal to the amount of nonqualifying income in excess of one-ninth of the RIC’s qualifying income. RICs may also 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. Failures of the asset diversification test 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 the net income generated by such nonqualifying assets will be subject to a penalty tax, with a minimum tax of $50,000. These new cure provisions are effective for any taxable years for which an income tax return due date is after December 22, 2010.

**Distribution Requirement.** The Act requires a RIC to distribute 98.2% of its capital gain net income for the one-year period ending on October 31 of the calendar year, which replaces the requirement to distribute 98 percent of its capital gain net income for the same period. This provision applies to calendar years beginning after December 22, 2010.

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1 See Willkie Farr & Gallagher LLP Client Memorandum of December 30, 2009.
RIC Funds of Funds. The Act provides that redemptions of open-end RIC shares made upon shareholder demand will be treated as exchanges in all cases and not as dividends. This provision applies to redemptions made after the date of enactment of the Act. The Act also permits a RIC solely invested in other RICs to pass through exempt-interest dividends, as well as foreign tax credits.

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

Spillback Dividends. The Act provides 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 must pay a declared spillback dividend before or with the payment of the next dividend of the same type, rather than before or with the payment of the “first regular” dividend, as currently required.

Post-October Losses and Excise Tax Coordination. The Act allows the deferral of post-December ordinary losses and post-October net short-term losses, in addition to the currently recognized post-October net loss deferrals and net long-term loss deferrals, in taxable years beginning after December 22, 2010. The Act provides 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 and provides that gain or loss that otherwise would be taken into account after October 31 will be taken into account in the following year. The Act allows 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 coordinates 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 will apply to calendar years beginning after December 22, 2010.

Earnings and Profits of RICs. The Act provides that a tax-exempt bond fund’s expenses and bond premium amortization reduce the fund’s current earnings and profits.

Tax-Exempt Bond Funds. The Act provides that the rule disallowing the loss on a sale or exchange of a share of a RIC where the shareholder received an exempt-interest dividend and held the share for less than six months does not apply to a RIC that declares exempt-interest dividends on a daily basis in an amount equal to at least 90 percent of its net tax-exempt interest and distributes such dividends monthly or more frequently. This provision applies to losses incurred on RIC shares for which the taxpayer’s holding period begins after December 22, 2010.
Losses Due to Load Charges. Under prior law, if RIC shares were sold within 90 days of the original purchase, shareholders were not able to recognize a loss on the original shares attributable to the amount of the load charge if the load charge was waived on a future RIC investment, but instead were forced to 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 applies only if the future RIC investment occurs on or before January 31 of the calendar year following the year in which the original shares were sold. This provision applies to charges incurred in taxable years beginning after December 22, 2010.

Repeal of Penalty on Deficiency Dividends. Under prior law, a RIC that distributed a deficiency dividend was required to pay a penalty that could have been as high as one-half of the amount of the dividend. The Act repeals this penalty.

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If you have any questions regarding this memorandum, please contact Joseph A. Riley (212-728-8715, jriley@willkie.com), James R. Brown (212-728-8287, jbrown@willkie.com), or the attorney with whom you regularly work.

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