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May 1, 2014

The Honorable Mary Jo White
Chair
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Rule on *Money Market Fund Reform; Amendments to Form PF*; Release No. S7-03-13
Tax Compliance Issues Created by Floating NAV

Dear Chair White:

We are writing on behalf of our client, Federated Investors, Inc., and its subsidiaries ("Federated"), to provide comments in response to the Securities and Exchange Commission's (the "Commission's") proposed rule on *Money Market Fund Reform; Amendments to Form PF* (the "Release").[1] Our comments in this letter will address the tax compliance issues that would result from the proposed rule's requirement that money market mutual funds ("MMFs") adopt a floating net asset value ("NAV"), unless specifically exempted.

As the Release acknowledges, if modifications to current federal income tax law are not made, "the tax reporting effects of a floating NAV could be quite burdensome for money market investors that typically engage in frequent transactions."[2] These effects would be particularly burdensome for institutional investors, as such investors generally must make their own tax calculations rather than receiving reporting from the fund. As discussed in further detail below, significant changes would be needed to the existing federal income tax rules regarding gain and loss recognition to eliminate the substantial tax compliance burdens

[1] *Money Market Fund Reform; Amendments to Form PF*, 78 Fed. Reg. 36834 (June 19, 2013) ("Release").
[2] Release at 36868.

associated with applying the floating NAV requirement to MMFs. Furthermore, it is not clear that the Treasury Department and the Internal Revenue Service (the "IRS") currently have the regulatory authority necessary to implement the required tax law changes. To the extent that the Treasury Department and the IRS view themselves as not having the necessary regulatory authority or are unwilling to exercise it, a legislative fix would be required. Regardless of whether an administrative or legislative approach is taken, the tax compliance issues, which are described below, must be completely resolved and final legislation or administrative guidance in place prior to applying a floating NAV concept to institutional MMFs to avoid a potentially disastrous exodus of capital from the affected MMFs.

I. Under current law, investors have tax consequences when the price of mutual fund shares changes between purchase and redemption.

It is a fundamental tenet of the federal income tax law that, when an investor sells or redeems a security for more or less than the seller's cost, the investor recognizes the resulting gain or loss and must report it on the investor's tax return for the year of the sale.[3] To calculate this gain or loss, the taxpayer must track both its cost or tax basis for the security and the price at which it sold or redeemed the security.[4] Certain taxpayers, such as individuals, receive annual reporting of such information and the amount of the resulting gains or losses from the issuer of the security or the broker through which the sale was made.[5] For taxpayers that are "exempt recipients," including corporations and most other institutional investors, the taxpayer must track this information and calculate the resulting gains and losses on its own.[6]

The Commission's floating NAV concept is proposed to apply only to institutional MMFs. Investors in institutional MMFs generally are corporations and other large institutional investors who use MMFs as a short-term investment vehicle and cash management tool.[7] The amount of their investment in an MMF will vary from day to day as their cash balances go up or down. With stable NAV MMFs, there is no need for an investor

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[3] I.R.C. § 1001 ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized."); *see also* I.R.C. § 451 ("The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.").

[4] *See* I.R.C. § 1001 (defining amount realized to include "the sum of any money received") and I.R.C. § 1012 ("The basis of property shall be the cost of such property….").

[5] I.R.C. §§ 6045, 6045A, 6045B.

[6] Treas. Reg. § 1.6045-1(c)(3)(i)(B).

[7] Release at 36842 (noting that institutional investors "rely on money market funds for their cash management operations because the funds provide diversified cash management more efficiently due both to the scale of their operations and their expertise").

to calculate or report gain or loss because the MMF maintains a stable $1 NAV per share and the redemption price of fund shares therefore always equals their cost.[8] Thus, "money market fund shareholders therefore generally need not track the timing and price of purchase and sale transactions for capital gains or losses."[9]

Under the floating NAV proposal, the price of institutional MMF shares would change daily, albeit by a small amount. As a result, taxable investors would be required to track the cost or tax basis and redemption price of all shares that they purchase and redeem. In addition, such investors would be required to track the timing of individual purchase and redemption transactions to determine whether the "wash sale" rules applicable under federal income tax law disallow any of the losses.[10] The existence and nature of this tax compliance burden is described in the IRS's recent proposed guidance regarding the application of the wash sale rules to floating NAV MMF shares.[11] The examples in that guidance clearly indicate the need for investors to track the small gains and losses that would be associated with redemptions of floating NAV MMF shares. Furthermore, because the investors in institutional MMFs generally are "exempt recipients,"[12] the tax compliance burden would fall squarely on the investors, rather than on the funds. For institutional investors that themselves hold accounts for non-retail customers, this could require calculating small gains and losses on hundreds or thousands of accounts.

Institutional investors in non-MMF mutual funds are required under current law to track the gains and losses associated with each share redemption. However, the quantity and frequency of such redemptions generally are far lower than in the case of MMFs. Because institutional MMFs are used as cash management tools by most investors, the balance of a particular investor's investment in an MMF typically will fluctuate on a daily basis. Consequently, the requirement to track small amounts of gains or losses from individual share redemptions that would result from applying a floating NAV concept to institutional MMFs would impose a substantial tax compliance burden on taxable investors. Furthermore, there is no similar tax compliance burden in the case of other, competing short-term investments, such as bank accounts, U.S. government MMFs, unregistered stable NAV funds, and separate accounts. As a result, the implementation of a floating NAV concept likely would drive most

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[8] Because of this feature, stable NAV MMFs are exempted from the basis reporting rules described above. Treas. Reg. § 1.6045-1(c)(3)(vi) ("No return of information is required with respect to a sale of an interest in a regulated investment company that can hold itself out as a money market fund under Rule 2a-7 under the Investment Company Act of 1940 that computes its current price per share for purposes of distributions, redemptions, and purchases so as to stabilize the price per share at a constant amount that approximates its issue price or the price at which it was originally sold to the public.").

[9] Release at 36868.

[10] I.R.C. § 1091; *see also* Release at 36869.

[11] Notice 2013-48, 2013-31 I.R.B. 120.

[12] Treas. Reg. § 1.6045-1(c)(3)(i)(B).

taxable investors away from MMFs to competing investment opportunities.[13] In other words, institutional investors would be effectively precluded from using their preferred cash management tool merely because of the tax administrative burden that would be associated with MMFs under a floating NAV concept. Since taxable investors comprise more than 85% of the investment in institutional MMFs,[14] the resulting exodus would put many funds out of business and would significantly reduce the capital base of the remaining funds, thereby making them both less efficient and less liquid.[15]

Based on the foregoing, it is clear that, if the tax compliance burden associated with a floating NAV cannot be eliminated, the application of that concept would be damaging to institutional MMFs and investors. It would also be counterproductive to the Commission's stated goals with respect to such funds, which include "preserv[ing] as much as possible the benefits of money market funds for investors and the short-term financing markets."[16] The remainder of this letter addresses the difficulty of eliminating that tax compliance burden without resorting to a legislative fix, which, of course, presents its own set of political and procedural challenges.

II. Eliminating the tax compliance burden associated with a floating NAV requires doing away with the need to track and report gains and losses on each share redemption.

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[13] *See* Letter from Center for Capital Markets Competitiveness to Financial Stability Oversight Counsel ("FSOC"), January 23, 2013 ("CCMC Letter") (commenting on FSOC-2012-0003, which proposed, among other things, floating NAV). In its letter, the Center for Capital Markets Competitiveness ("CCMC") stated that the changes in the FSOC proposal, including floating NAV, "render [MMFs] useless for investors." CCMC Letter at 5. CCMC also stated that tracking the "very small short-term capital gains or losses" would "create an additional burden for MMMF shareholders that will deter many of them from investing." CCMC Letter at 6. In addition, "[a]s many investors are not able to tolerate or invest in a product without a stable value, MMMFs will no doubt see a reduction in investments." CCMC Letter at 11.

[14] *See* Table 59: Total Net Assets of Institutional Investors in Taxable Money Market Funds by Type of Institution and Type of Fund, 2013 Investment Company Institute Fact Book, 53rd Edition; available at http://www.icifactbook.org/fb_data.html.

[15] *See* Comment Letter of the Investment Company Institute to the Securities and Exchange Commission, dated September 17, 2013 (available in File No. S7-03-13) ("ICI Letter") ("Requiring prime institutional money market funds to float their NAVs risks precipitating an outflow of hundreds of billions of dollars from prime money market funds to other products, including government money market funds. This could result in a major restructuring and reordering of intermediation in the short-term credit markets, and the transition is likely to be highly disruptive."). The ICI also stated that "the operational changes required are so extensive, difficult, and costly that sponsors and intermediaries are unlikely to make the substantial investment required, unless they believe investors would accept a floating NAV product in meaningful numbers." ICI Letter at 28. At the same time, the ICI noted that a recent survey "found that 65 percent of organizations surveyed would be less willing to invest in floating NAV money market funds." ICI Letter at 37.

[16] SEC Fact Sheet, June 5, 2013 (accessed at *http://www.sec.gov/News/Article/Detail/Article/1365171576956*); *see also* Release at 36834, 36837, 36848.

To date, the only guidance that has been issued by the IRS with respect to the floating NAV concept is a proposed revenue procedure that would make the wash sale rule inapplicable to purchases and sales of MMF shares if the losses are below a specified threshold.[17] The Release indicates that the Treasury Department and the IRS are also considering guidance that would allow (i) mutual funds to report net information regarding gains and losses recognized on sales of their shares and (ii) shareholders to report summary information on their returns regarding sales of mutual fund shares.[18] However, eliminating the tax compliance burden on institutional MMF shareholders associated with the floating NAV concept would require much more in the way of guidance. The proposed revenue procedure would not make the wash sale rule inapplicable to all sales of MMF shares, but would merely disengage it if the recognized losses are below a specified threshold. As a result, MMF shareholders would still be required to gather and retain information regarding the possible application of the wash sale rule for fear that losses might exceed the threshold. Similarly, simplifying the reporting of gains and losses from sales of MMF shares on a shareholder's tax return is helpful in a limited sense, but it does not obviate the need to track and retain the information necessary to calculate the gains and losses that would be recognized on individual share redemptions, which can occur on a daily basis.

Eliminating the tax compliance burden on institutional MMF shareholders associated with the floating NAV concept would require the issuance of two types of guidance. First, it would be necessary to provide full relief from the wash sale rule to the extent that losses are recognized on MMF investments. Without this full relief, institutional MMF shareholders would still have significant tax compliance obligations relating to the wash sale rule.

The second and more important type of guidance that would be required is a modification of the basic gain and loss recognition regime that would eliminate the need to track gains and losses from individual MMF share redemptions. One way to achieve this goal would be to use to a "mark-to-market" tax accounting method for floating NAV MMF investments. Under this methodology, the amount of gain or loss recognized by an institutional MMF shareholder during a year would equal (i) the value of the shareholder's shares in the fund at the end of the year, plus (ii) any share redemption proceeds received from the fund during the year, minus (iii) any additional amounts invested in the fund during the year, and minus (iv) the value of the shareholder's shares in the fund at the beginning of the year. A second way to accomplish this objective would be to apply an "open transaction" approach to the taxation of floating NAV MMF share redemptions.[19] Under this approach, any gains would not be recognized until a shareholder had received aggregate share redemption proceeds from a particular MMF in excess of the shareholder's aggregate

[17] Notice 2013-48.
[18] Release at 36868.
[19] *Cf. Burnet v. Logan*, 283 U.S. 404 (1931); *Lucas v. N. Tex. Lumber*, 281 U.S. 11 (1930).

investment in that fund. Any losses would be deferred until complete liquidation of the shareholder's investment in that fund. A final option, which represents an even further departure from existing federal income tax law, would be to provide that gains and losses from MMF share redemptions are ignored and never recognized for tax purposes under the theory that such amounts are always *de minimis*. As indicated in the next section, it is unclear whether the Treasury Department and the IRS have the regulatory authority to implement any of the foregoing guidance.

III. No clear regulatory authority exists to allow investors in floating NAV MMFs not to track and report gains and losses from share redemptions.

The Treasury Department and the IRS derive regulatory authority in two ways. First, when Congress enacts or amends a section of the Internal Revenue Code (the "Code"), it can make a specific grant of authority to the Treasury Department to issue appropriate regulations.[20] The section that requires taxpayers to recognize gains and losses when they dispose of securities does not contain a specific grant of authority.[21] Second, the Treasury Department also has general authority to "prescribe all needful rules and regulations for the enforcement" of the internal revenue laws.[22] Regulations, of course, cannot directly conflict with the statutes passed by Congress.[23]

As noted above, in the wake of the Release, the IRS issued a proposed revenue procedure designed to mitigate the tax compliance burdens resulting from applying a floating NAV concept to institutional MMFs.[24] As discussed above, the proposed revenue procedure does not, in fact, eliminate the wash sale compliance burden because investors must still track losses on, and the timing of, individual share purchases and redemptions to determine whether the safe harbor in the proposed revenue procedure applies. The proposed revenue procedure provides the following rationale for its adoption:

> Redemptions of share of MMFs, which have relatively stable values even when share prices float, do not give rise to the concern that § 1091 is meant to address. Moreover, given the expected volume of transactions in MMF shares, tracking wash sales of MMF shares will present shareholders of floating-NAV MMFs with significant practical challenges. Therefore, it is in the interest of sound tax administration to

[20] *See, e.g.,* I.R.C. § 860G(e) ("The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part ….")

[21] I.R.C. § 1001.

[22] I.R.C. § 7805(a).

[23] *See Mayo Foundation for Medical Educ. & Research v. U.S.*, 131 S.Ct. 704, 711 (2011) (holding that the first question in evaluating a Treasury regulations is "whether Congress has 'directly addressed the precise question at issue'")

[24] Notice 2013-48.

> prescribe circumstances in which the IRS will not treat a redemption of these MMF shares as part of a wash sale under § 1091.[25]

Because there is no specific grant of regulatory authority in the wash sale provisions of the Code, the adoption of the proposed guidance presumably would be based on the general regulatory authority of the Treasury Department and the IRS.

The proposed revenue procedure suggests the IRS's views on the limits of its regulatory authority. In particular, it clearly assumes that gains and losses will be recognized on individual share redemptions, despite the small size of such gains and losses. There is no indication that the IRS considers itself to have the authority to turn off the recognition of those gains and losses. Moreover, the wash sale rule is an anti-abuse provision.[26] It is one thing for the IRS to decide that a certain type of transaction does not violate the spirit of a statutory anti-abuse provision and to turn off the application of that provision in a particular context or set of circumstances. It is quite another matter for the IRS to eliminate, defer, or accelerate gain or loss recognition with respect to sales of securities where such gain or loss recognition is a longstanding, bedrock principle of the federal income tax law. Thus, it is unclear whether the IRS has, or views itself as having, the regulatory authority to do anything other than simplify the tax reporting that is required with respect to MMF share redemptions. Such reporting simplification would be helpful in a limited way, but clearly would not eliminate the need to track a large number of small gains and losses from individual share redemptions that would result from applying a floating NAV concept to institutional MMFs.

Although the Treasury Department and the IRS have general regulatory authority, they cannot issue a regulation that conflicts with a statute passed by Congress.[27] Providing that gains and losses from MMF share redemptions would never be recognized clearly conflicts with the applicable statutory gain and loss recognition provisions, even if the gains and losses in question are very small. Similarly, providing for open transaction treatment that defers recognition of such gains and losses, perhaps indefinitely, stretches the statutory fabric of both the gain and loss recognition rules and the annual accounting concept that is fundamental to the federal income tax system. Finally, imposing a mark-to-market tax accounting

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[25] *Id*.

[26] The wash sale provision was first adopted in 1921 and is currently found in Section 1091 of the Code. The wash sale provision prevents taxpayers from selling stock or securities to claim a loss, while at or about the same time, purchasing substantially identical securities so that the taxpayer's overall economic position remains unchanged. The guiding principle was that if the taxpayer's economic position remained unchanged, then the deduction of a loss should not be allowed. In the 1921 House bill including the wash sale disallowance, the House Ways and Means Committee report stated that "This change will, if adopted, prevent evasion of the tax through the medium of wash sales. [H.R. Rept. No. 350, 67th Cong., 1st sess., p. 11.]" *Hanlin v. Comm'r*, 38 B.T.A. 811 (1938), *aff'd*, 108 F.2d 429 (3d. Cir. 1939).

[27] *See* supra note 23.

methodology, or allowing its use on an elective basis, is not something that the Treasury Department and the IRS typically have done in the absence of specific statutory authorization. [28] Thus, it is by no means clear that the Treasury Department and the IRS have, or view themselves as having, the regulatory authority to eliminate the tax compliance burden of tracking and reporting the large number of small gains and losses that would result from the application of a floating NAV concept to institutional MMFs. In absence of such regulatory authority (or the willingness to exercise it), that tax compliance burden could only be eliminated by Congressional action.

IV. It is not clear that additional Treasury Department or IRS guidance would resolve the investor tax compliance burden associated with floating NAV MMFs.

The Release acknowledges that if modifications to current law are not made, "the tax reporting effects of a floating NAV could be quite burdensome for money market investors that typically engage in frequent transactions."[29] As noted above, for institutional investors, this burden falls primarily on the investor, rather than the fund. The Financial Stability Oversight Council recognized in its *Proposed Recommendations Regarding Money Market Mutual Fund Reform* (November 2012), that with a floating NAV,

> because each redemption of MMF shares could produce a gain or loss for the shareholder, it would be necessary to determine for every redemption—(i)

[28] Congress has required or permitted mark-to-market tax accounting in a limited number of situations. *See, e.g.,* I.R.C. § 475 (requiring securities dealers to mark their inventory to market and permitting commodities dealers and securities and commodities traders to mark their inventory to market); I.R.C. §1256 (requiring regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts to be marked to market); I.R.C. §1296 (permitting mark to market accounting for certain passive foreign investment company stock); *see also* I.R.C. §1259 (requiring gain recognition based on market value if the taxpayer makes a constructive sale of an appreciated financial position). The situations in which the Treasury Department has issued regulations allowing mark-to-market accounting have been even more limited. Treasury regulations that preceded Section 475 of the Code permitted a securities dealer to determine the value of its inventory based on market value if that is how the dealer kept its books of account. Treas. Reg. §1.471-5 (note that this regulation is obsolete since the passage of I.R.C. §475, although it has not yet been removed). This guidance was issued to permit conformity between financial and tax accounting , which is a special consideration that is not present in the case of the application of floating NAV to MMFs. The Treasury Department also has issued proposed regulations relating to contingent payment swap agreements that would permit the use of mark-to-market accounting for such instruments. Prop. Treas. Reg. §1.446-3(i) (permitting mark-to- market accounting for notional principal contracts with nonperiodic payments). However, in a related notice, the IRS raised the question as to whether regulatory authority exists to impose a mark-to-market tax accounting regime in the context of contingent payment swaps. Notice 2001-44, 2001-2 C.B. 77, §II.A.4.c(iii). Thus, it is not clear to what extent the Treasury Department and the IRS have general regulatory authority to impose or allow mark-to-market tax accounting, and such authority has only been exercised in very limited circumstances in the absence of a specific legislative authorization.

[29] Release at 36868.

which share was redeemed, (ii) the tax basis (generally, the acquisition cost) of that share, and (iii) whether the holding period of that share was long term or short term.

Although the Release indicates that the Treasury Department and the IRS are considering additional guidance that would allow aggregate or net reporting of gains and losses from MMF share redemptions, such guidance, while helpful in a limited way, would not relieve fund shareholders of the burden of tracking large numbers of small gains and losses to derive the aggregate or net amount of gain or loss.

As noted above, the currently existing proposed IRS guidance assumes that fund shareholders will recognize gains and losses on individual MMF share redemptions and that those gains and losses will need to be tracked. In addition, because the proposed wash sale safe harbor depends on the shareholder's loss as a percentage of the shareholder's basis in the fund shares, the proposed guidance would not eliminate a shareholder's need to track the tax information relating to each and every purchase and sale of fund shares. The IRS stated in the Notice that "given the expected volume of transactions in MMF shares, tracking wash sales of MMF shares will present shareholders of floating-NAV MMFs with significant practical challenges."[30] The same is true of tracking large numbers of small gains and losses relating to individual share redemptions.

Thus, neither the proposed wash sale guidance nor the summary reporting type of guidance that the Release has suggested may be under consideration would obviate the need for floating NAV MMF shareholders to track and calculate large numbers of small gains and losses. As noted above, it is not clear that the Treasury Department and the IRS have regulatory authority to issue guidance that would eliminate this tax compliance burden. Even if such regulatory authority exists, it is by no means clear that the Treasury Department and the IRS will be willing to issue administrative guidance that is feasible for MMF shareholders to implement and that actually eliminates the tax compliance burden associated with the application of a floating NAV concept.

V. The floating NAV concept should not be implemented unless and until guidance that effectively eliminates the resulting tax compliance burden is in place.

As discussed above, converting to a floating NAV would cause fund shareholders to recognize small gains and losses with respect to redemptions of MMF shares. Because the floating NAV proposal applies only to institutional MMFs, it is expected that, in general, fund shareholders, rather than the funds themselves, will be required to track and calculate these

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[30] Notice 2013-48.

gains and losses. Because institutional investors use MMFs as a cash management tool, they typically engage in share purchases and redemptions on a daily or weekly basis. Accumulating and maintaining the information necessary to calculate the numerous small gains and losses resulting from frequent share redemptions would require significant time and expense on the part of fund shareholders. If this tax compliance burden cannot be eliminated, it is likely that most taxable institutional investors would abandon MMFs for other short-term investment alternatives that have a stable NAV and therefore do not require tracking and calculating cost or tax basis and redemption price. This exodus of capital from institutional MMFs would be damaging to the funds and the issuers of securities that are purchased by such funds. At the same time, institutional investors would be damaged because they will be precluded from using their preferred cash management tool merely because of the unsupportable tax administrative burden that would be imposed by the floating NAV concept. Finally, it also would be counterproductive to the Commission's stated goals with respect to MMFs, including preserving the benefits of MMFs for investors. For these reasons, the Commission should not implement the floating NAV proposal unless and until the Treasury Department or the IRS has issued administrative guidance that in fact eliminates the tax compliance burden on institutional MMF shareholders.

Respectfully submitted,

George C. Howell III

cc: The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
The Honorable Michael S. Piwowar
The Honorable Kara M. Stein