

## It's Time to Modernize the RIC Tax Rules

The Trump Administration should modernize tax rules applicable to mutual funds and exchange-traded funds (ETFs) to benefit the millions of Americans that invest for their future using funds.

These funds, as well as other regulated investment companies (RICs), are taxed as corporations subject to special rules under Subchapter M of the Internal Revenue Code (the RIC tax rules) and an excise tax. Those rules generally provide RIC shareholders with the same tax benefits that they would receive if they invested directly in the assets held by the RICs. There are six categories of legislative proposals that would modernize these rules and benefit fund shareholders. ICI can provide more detail at the transition team's request.

- **Ease the asset diversification requirements in Subchapter M.**
  - Waive the RIC asset diversification requirements in certain circumstances. For example:
    - for funds that are diversified under the Investment Company Act of 1940.
    - for funds that fail the RIC asset diversification test due to market fluctuations.
    - adopt a start-up year rule so that RICs do not need to satisfy the RIC asset diversification rule in their first year of operation.
  - Ease the RIC asset diversification restrictions, for example:
    - delete the 5/10/50% test in §851(b)(3)(A), or
    - increase the 5/10% limits in §851(b)(3)(A)(ii), or
    - lower the 50% limit in §851(b)(3)(A), or
    - increase the 25% limit in §851(b)(3)(B), or
    - delete the 25% limit on securities of two or more issuers “engaged in the same or similar trades of business” in §851(b)(3)(B)(ii), and the applicable sections of §851(c) (1), (2), and (3), or
    - some combination of these options.
  - **Background:** To qualify as a RIC, a fund must satisfy the asset diversification requirements of Subchapter M. The RIC asset diversification rules limit a fund's investment concentrations, through 2 tests:
    - A 25% test – the fund cannot invest more than 25% of its assets in any single security (other than RICs), or the securities of two or more controlled issuers (other than RICs) in the same or similar businesses, or the securities of one or more qualified publicly traded partnerships.

- A 5/10/50% test – the fund cannot invest half (or more) of its assets in securities that are each more than 5% of the fund’s assets, or that represent more than 10% of the voting stock of a company. Said another way, the fund’s aggregated investments in securities exceeding this 5/10% limit cannot be 50% or more of the fund’s assets.

The RIC asset diversification tax requirements were enacted in 1936, predating the asset diversification requirements in the ’40 Act, and should be understood in that context. Given that lack of federal legislation governing investment funds at the time, Congress used the Internal Revenue Code to enact non-tax policy, including limitations on the types of income that RICs are permitted to receive (the “good income test”), and the concentration of investments (the asset diversification requirements). Later, the ’40 Act introduced a similar asset diversification rule for diversified funds. Investment concentration limits seem better addressed through securities law and regulation than in the Internal Revenue Code.

- Need for Change: Investors want access to modern investment strategies in a regulated fund, but many RICs cannot access or properly replicate these investment strategies due to the asset diversification tax limitations. This is important as, for example, large-cap tech stocks such as Apple, Nvidia, and Microsoft have seen significant runups and now comprise a large percentage of the S&P 500. These rules restrict a fund’s ability to invest in certain sectors of the economy, in some countries, and even in certain states that have few issuers of municipal bonds. The consequences of failing are severe if not cured under prescribed rules. A RIC that fails qualification pays tax on its net income exclusive of the dividends paid deduction (effectively the RIC’s gross income, less expense) and would experience large outflows from investors and likely liquidation of the fund.
- **Expand the types and amounts of income that funds can receive without losing regulated investment company (RIC) status.**
  - repeal the RIC “good income” test, or
  - expand the categories of permitted income to permit investments in and income from digital assets, commodities, and private investments, and/or
  - reduce the punitive effect of the tax on bad income.
- Background:
  - Subchapter M requires RICs to derive at least 90% of their gross income from dividends, interest, securities loans, gains from stock or securities or foreign currencies, or other income derived with respect to its business of investing. This is known as the “good income” test. It generally limits RICs to investments in stock, bonds, other securities, currencies, a specific type of partnership (capped at 25%), and derivatives referencing stocks, bonds, or securities. Income that doesn’t qualify as “good income” is often called “bad income.” A fund with more than 10% bad income must pay a punitive tax on the bad income and may fail to qualify as a RIC, subjecting the fund to 21% corporate tax on its income.
  - The securities law also requires funds to generate income “primarily” from securities.

- Need for Change.
  - Investor Choice—The RIC tax rules prevent RICs from investing in many portfolio-diversifying alternative asset classes that are popular among investors, including cryptocurrencies and digital assets supported by President-elect Trump, metals and other commodities, private equity and venture capital, private debt, and real estate. Wealthy and high-income investors can qualify as “accredited investors,” who are permitted to invest directly in alternative assets through private fund structures (private placements). Ordinary investors who have less income and wealth can’t purchase private placements. This effectively precludes ordinary investors from accessing private investment assets, which are increasingly important as fewer companies are publicly traded (over 50% decline since the 1990s).
  - Duplication with Securities Law—The good income rules date back to 1936, before the securities law included similar requirements. Restricting or regulating fund investments is a matter of securities law and regulation, not tax law or tax policy.
  - Severe Consequences of Failure—The consequences of failing to satisfy the “good income” requirement can be costly and dire for shareholders. Funds failing the “good income” test fail to qualify as a RIC if they cannot establish that the failure was due to reasonable cause, incurring 21% corporate tax, which would likely result in large outflows from the fund and potential liquidation of the fund. Even if the fund can establish that the failure was due to reasonable cause, the tax on bad income is highly punitive—over 100% of the amount exceeding the 10% limit.
- **Ease restrictions on certain RIC distributions that limit tax benefits for shareholders.**
  - permit electronic delivery of all tax information for fund distributions,
  - provide relief from minimum investment limits for liquidating municipal bond funds and international funds, which prevent shareholders from receiving tax benefits on distributions from liquidating funds,
  - permit funds to pass through to shareholders short-term capital gains, otherwise taxed as ordinary income to the investor, and foreign-source income from specific countries (country-by-country sourced income), and
  - repeal the one-per-year rule for long-term capital gain distributions in the Investment Company Act of 1940 and/or modify the tax rules allocating earnings and profits (E&P) to distributions.
- Background. Current law limits or restricts shareholder tax benefits from RIC distributions unless certain requirements are met. These include:
  - Requirements to provide shareholders with tax information through “written statements” that do not specify the means of delivering the information.
  - Rules that deny shareholders with tax benefits for distributions from liquidating municipal bond funds (exempt-interest dividends), and international funds (foreign tax credits), because a liquidating fund cannot hold at least 50% of its assets in municipal bonds or foreign securities when it liquidates.

- RICs cannot pass-through net short-term capital gains from the fund to shareholders. Short-term gains are distributed as ordinary income.
- RICs cannot pass-through foreign-source income to foreign investors, who could potentially benefit from lower tax rates on that income.
- The Investment Company Act of 1940 limits capital gain distributions to one per year. SEC regulations permit a second distribution, and in certain circumstances, a third.
- Subchapter C requires RICs to allocate E&P to distributions in a mechanical way that prevents funds from making capital gain distributions in scenarios where distributions exceed current year earnings and profits.
- Need for Change: These RIC distribution requirements and limitations deny tax benefits to shareholders and create unnecessary complexities that increase shareholder confusion and costs. Fund shareholders are losing tax benefits that Subchapter M was intended to provide.
- **Modernize rules applicable to variable insurance product (VIP) funds.**
  - Permit variable annuity separate accounts to invest in a VIP fund that holds 100% of its assets in securities issued by a single government agency (for example, United States Treasury bonds).
  - Remove requirements to restrict ownership of VIP fund shares exclusively to insurance companies (and certain other qualified investors) or permit such funds to invest in other RICs that are not held exclusively by insurance companies.
  - Background:
    - Variable insurance product (VIP) funds are a type of RIC held by insurance companies that issue variable insurance policies and variable annuity contracts. VIP funds are subject to special tax rules in section 817 of the Code, in addition to the RIC tax rules of Subchapter M. These rules generally treat the insurance companies, and not their policyholders, as the owners of the VIP fund shares for tax purposes if the policies and VIP funds meet certain requirements.
    - One of these rules permits variable insurance policies to invest in a VIP fund that holds 100% of its assets in securities issued by a single government agency (for example, United States Treasury bonds) but prohibits variable annuity funds from doing so.
    - Another rule effectively prevents VIP funds from investing in a RIC unless all shares of the RIC are held by insurance companies (or certain other limited investors). To comply with this rule, asset managers need to create special-purpose VIP funds that cannot be held by other investors. Recent legislation (SECURE 2.0) directs the US Treasury to amend its regulations to allow for the establishment of insurance-dedicated (VIP) ETFs. However, VIP funds currently cannot be exchange-traded because of the rule restricting VIP fund share ownership to insurance companies.

- Need for Change:
  - **Promote Investor Choice**—These restrictions limit investment options for policyholders of variable insurance or variable annuities. Tax rules shouldn't prevent investors from seeking the safety of investing in government securities. Permitting VIP funds to invest in RICs that aren't exclusively held by insurance companies would provide investors with many more investment options.
  - **Severe Consequences of Failure**—The consequences of a VIP fund failing these requirements are severe. If a VIP fund fails to restrict share ownership to insurance companies, the variable life insurance policies and variable annuity contracts would fail to qualify for taxation as insurance/annuity products, and the contract holders would be subject to tax directly on the income generated by the VIP funds. This would effectively terminate those contracts and the VIP fund.
  - **Compliance Burdens**—These restrictions impose unique compliance burdens for VIP funds that are not imposed on other RICs.
- **Modify the RIC excise tax distribution requirements (4982) to reduce compliance costs impacting investment returns.**
  - lower the excise tax distribution requirements from 98% and 98.2% to a lesser percentage (e.g. 90%), or
  - permit a fiscal-year-to-date calculation of the excise tax distribution requirement, or
  - a combination of both proposals.
  - Background: The RIC excise tax rules impose a 4% excise tax on RICs that do not distribute by December 31 essentially all income earned during the calendar year. (See § 4982). Specifically, a RIC must distribute at least 98% of its ordinary income for the calendar year, 98.2% of its capital gain net income for the 12-month period ending on October 31, and 100% of any previously undistributed amounts arising in prior years. The 4% excise tax applies to the under-distributed amount. RICs often have a fiscal year (tax year) other than the calendar year. For these funds, they have three separate tax calculation periods: two for excise tax purposes, and another for income tax purposes.
  - Need for Change. Funds incur significant compliance costs from managing three different complex and overlapping tax calculation periods. The costs are ultimately borne by the funds' shareholders, who would benefit from easing excise tax compliance burdens. These proposals ease administrative burdens and costs while preserving the core anti-deferral purpose of the excise tax.

- **Address other tax requirements that limit the ability to manage fund operations in the best interest of fund shareholders.**
  - Permit RICs to take the net operating loss (NOL) deduction.
    - Background: RICs are currently prohibited from taking a net operating loss (NOL) deduction.
    - Need for Change: The lack of NOL deduction provides a competitive disadvantage for RIC shareholders, compared to individuals who invest directly in securities. RIC shareholders bear the burden of excess tax in future years, as the RIC cannot use the NOL to offset future income, increasing future dividends. This lack of NOL deductions has become much more problematic because of the proliferation of investments that generate ordinary income and loss. Permitting funds to carry forward NOLs ensures that fund shareholders are not taxed on amounts greater than their economic income. Almost all other taxpayers (individuals, corporations, etc.) can take an NOL deduction. There is no apparent policy rationale for denying RICs the NOL deduction. The disallowance of RIC NOLs dates back at least to the 1954 Internal Revenue Code and is ripe for modernization. At the time, the range of investment products was much more limited than it is today, and the Internal Revenue Code did not yet include many of the provisions that now characterize certain income and gains as ordinary.
  - Exempt RICs from the personal holding company (PHC) rules.
    - Background: The PHC rules subject certain closely held corporations to additional tax on undistributed passive income. As corporations, RICs are subject to the PHC rules in certain circumstances where RICs have more than 50% of their shares held by five or fewer “individuals” (which includes certain types of institutions), subjecting RICs to the PHC surtax. This may occur when a RIC is starting up or winding down in liquidation. Inadvertent triggering of the PHC rules would result in substantial additional fund-level tax.
    - Need for Change: Compliance with the PHC rules adds costs and can result in additional tax on RICs, which are borne by their shareholders. The policy behind the PHC rules does not apply to RICs. The PHC rules are intended to prevent individuals from avoiding higher individual income tax rates by using a corporation and tax deferral to shelter income and gains. RICs are not intended to be closely held—they are widely held by many shareholders. Shareholders cannot effectively use RICs for tax deferral, as the RIC must distribute all income at least annually to avoid incurring corporate income tax and 4% excise tax. The PHC rules predate the RIC excise tax rules, which now address the same anti-tax-deferral concerns that prompted the PHC rules. Testing to ensure RIC compliance with the PHC rules is cumbersome—particularly when large blocks of shares are held in omnibus accounts with brokers who hold the shares in “street name” and the RIC cannot identify the actual shareholders.

- Remove limitations referencing “publicly offered” RICs.
  - Background: Certain provisions of Subchapter M and other Code sections differential between “publicly offered” RICs and other RICs. For most of these purposes, the term is defined as a RIC the shares of which are:
    - continuously offered pursuant to a public offering,
    - regularly traded on an established securities market, or
    - held by or for no fewer than 500 persons at all times during the taxable year (subject to exceptions provided by regulation).
  - Need for Change: The policy rationale for differentiating between publicly offered RICs and other RICs is tenuous at best. Presumably, the purpose was to differentiate between RIC shares that are broadly held, actively marketed, distributed, traded, or continuously redeemable and shares of RICs that are privately held. In practice, certain closed-end funds such as interval funds and tender offer funds may have limited trading, marketability, and redemptions and small shareholder bases, and so inadvertently fail to qualify as “publicly offered.” These failures result in adverse tax consequences for funds and shareholders. These funds do not seem to implicate any policy concerns underlying the rules that include these “publicly offered” RIC requirements.