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***By Electronic Delivery***

June 14, 2018

David Kautter
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

William M. Paul
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Guidance Priority List Recommendations

Dear Mr. Kautter and Mr. Paul:

The Investment Company Institute[1] recommends the following issues affecting regulated investment companies (RICs) and their shareholders for inclusion on the 2018-2019 Guidance Priority List.[2] As requested in Notice 2018-43, these recommendations have been listed in order of priority. The Institute notes, however, that there are many outstanding issues that are important to the industry; additional items that have been included in prior requests for guidance from the IRS and the Treasury Department are included below as Enclosure A.

## I. Guidance to Implement 2017 Tax Law Changes

Interpretive guidance is needed to resolve uncertainties arising from the 2017 tax law changes (Pub. L. No. 115-77 (the Act)).[3] We appreciate that the Treasury Department and Internal Revenue Service (IRS) have focused their efforts on such guidance projects. We recognize that our recommendations

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$21.8 trillion in the United States, serving more than 100 million US shareholders, and US$7.6 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] A separate submission describes our Guidance Priority List recommendations for retirement security issues.

[3] *See* the Institute's letters on (1) amended Section 451(b) to Tom West and William Paul, dated May 4, 2018; (2) Section 965 Transition Tax on Deferred Foreign Income to Chip Harter, dated March 15, 2018; and (3) Section163(j) interest limitation expense to Tom West, dated March 1, 2018.

related to implementation of the Act already may be covered by the third-quarter update to the 2017-2018 Priority Guidance Plan; we nonetheless have included them as they are priority issues for the industry.

### A. Pass-Through of Section 199A Deduction to RIC Shareholders

The Institute urges guidance clarifying that RIC investors, in appropriate situations, may benefit from the Act's 20 percent deduction for a taxpayer's "qualified business income," plus certain dividends from real estate investment trusts (REITs), cooperatives, and publicly traded partnerships, including oil and gas master limited partnerships (MLPs). Although the statutory language does not provide an express mechanism for RICs that invest in such entities to pass through the 20% deduction to RIC shareholders, the Secretary is directed to prescribe regulations as necessary to carry out the application of section 199A to "tiered entities."

Specifically, the Institute requests that the Treasury Department and IRS exercise the authority granted under sections 199A(f)(4)(B) and 7805 to permit RICs, as tiered entities, to flow through the character of qualified business income and dividends to their investors. If guidance on the application of the new rules to tiered entities is not issued, RIC investors will be unable to benefit from this capital formation incentive. Further, it would be a significant tax policy shift that would harm average investors and frustrate the intended benefits of the Act.

### B. Amended Section 451(b)

The Institute and its members are concerned about the scope of the amendments to section 451(b) in the Act.[4] Although we believe the correct reading of the statutory language, consistent with Congressional intent, is quite limited, we welcome confirmation that section 451(b) will not be interpreted as effectively overriding the long-standing statutory and regulatory provisions on the accrual of market discount and original issue discount (OID). In some cases, the resulting timing differences may be significant; in others, the differences may be minor, and any potential benefit to the government would be far outweighed by the compliance burden that RICs would bear.

The Institute thus urges the Treasury Department and IRS to confirm that amended section 451(b): (1) does not apply to market discount; and (2) applies to OID only with respect to items, such as certain fees, that are treated as something other than discount under Generally Accepted Accounting Principles (GAAP).

[4] *See* Institute letter to Tom West and William Paul, dated May 4, 2018.

### C. Section 965 Transition Tax on Deferred Foreign Income

The Institute is concerned about the application to RICs of the new transition tax on deferred foreign income in section 965, as amended by the Act.[5] RICs, as corporations, are subject to the new rules to the extent that they own 10 percent or more of a foreign corporation. The Act, however, does not address how such amounts impact a RIC's qualification tests and distribution requirements under Subchapter M or the application of the excise tax rules under section 4982.

If these rules are not clarified, the consequences to RICs and their investors could be significant, resulting in entity-level income and excise tax as well as increased taxable ordinary and capital gain dividends to shareholders. We thus ask the Treasury Department and IRS to exercise the authority granted under sections 965(o) and 7805(a) to:

- Clarify that any deferred income should be ignored or treated as qualifying income for purposes of the RIC income qualification requirements in Subchapter M;
- Permit RICs to elect to include such income over the eight-year period available to other taxpayers for both income and excise tax purposes, thus spreading the required distribution of such amounts over the same period;
- Clarify that a RIC's share of deferred foreign income from a specified foreign corporation with a calendar year-end is treated as arising on January 1, 2018, for purposes of section 4982 and thus is first included in excise tax calculations for 2018, not 2017; and
- Provide relief for all taxpayers in situations in which the foreign corporation will not or cannot provide the information necessary for a RIC or other US shareholder to determine its share of any deferred foreign income under US tax principles.

### D. Section 163(j) Interest Expense Limitation

The Institute appreciates the confirmation in Notice 2018-28 that all interest expense and income of corporations is business interest expense and income. Additional guidance, however, is needed. Specifically, we urge the Treasury Department and the IRS to exercise their regulatory authority under section 163(j)(8)(B) to clarify that (1) a RIC's adjusted taxable income includes all of its income and gains; and (2) a RIC's adjusted taxable income for purposes of the new limitation is determined before the application of the dividends paid deduction (DPD) under section 561.[6]

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[5] *See* Institute letter to Chip Harter, dated March 15, 2018.

[6] *See* Institute letter to Tom West, dated March 1, 2018.

## II. Section 851 Investments in CFC and PFICs

We request that the IRS and Treasury Department modify the proposed regulations issued under section 851 relating to whether investments by RICs in controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs) qualify as "good income" under section 851. Specifically, the proposed regulations provide that Subpart F inclusions from a CFC and qualified electing fund (QEF) inclusions from a PFIC (1) will be treated as "dividends" only to the extent that the CFC or PFIC has made a distribution out of its earnings and profits, and (2) will not be treated as "other income" derived with respect to a RIC's business of investing in stock, securities or currencies (the Other Income Proposal).

The section 965 inclusion described above creates additional concerns for RICs if the proposed regulation is finalized, given the unlikelihood that a distribution will accompany such inclusion. Similar concerns arise with respect to amounts included in income under the new global intangible low-taxed income (GILTI) regime. The Act specifically provides that inclusions under both section 965 and the GILTI regime are treated as Subpart F inclusions under section 851(b). If the inclusions are treated as "non-qualifying" income under the proposed regulations, it will have significant implications for RICs and shareholders.

The Institute strongly urges that the IRS and Treasury Department strike the Other Income Proposal from the final regulations as it would reclassify many Subpart F and QEF inclusions as bad income.[7] This request is supported by sound tax policy and is consistent with Congressional intent.

The Institute also recommends that Revenue Rulings 2006-1 and 2006-31, and other similar guidance, remain in effect. This guidance is consistent with current law and revoking them might create additional uncertainty about other investments routinely made by RICs.

## III. Qualified Interest Income

The Institute appreciates that the Treasury Department and IRS have issued guidance over the past few years to address the newly applicable SEC money market rules and prevent tax considerations from undermining a RIC's ability to meet them. One last issue arising from the resulting increased demand for government securities, however, must be addressed for these RICs to remain attractive for foreign investors.

Specifically, RICs are being forced by the increased demand for government securities to gain this exposure through repurchase agreements (repos) on government securities. Disparities in banking regulations, however, are causing banks to conduct their repo business through foreign branches that, as a general matter, result in "foreign source" income.

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[7] *See* Institute letter to William Wilkins and Tom West, dated December 22, 2016.

For government money market funds to make distributions that are fully exempt from US withholding tax as qualified interest income (QII) when paid to foreign investors, the income must have a US source. US tax is problematic for foreign investors using money market funds for cash management purposes, particularly when non-US alternatives are available.

The Institute therefore requests guidance that amounts received on repos, that are collateralized solely by US government securities (as that term is applied under Subchapter M), will be treated as US source income in determining QII under Code section 871(k)(1)(E).[8]

## IV. Foreign Tax Recoveries from European Union Member States under *Santander*

The Institute urges the IRS to issue guidance standardizing the terms of any closing agreement necessary to address situations not covered by Notice 2016-10; this Notice, as you may know, provides an administrable solution for the US fund industry's receipt of withholding tax refunds following the European Court of Justice (ECJ) decisions in *Santander*[9] and *DFA Emerging Markets.*[10] Specifically, we urge a uniform methodology for calculating the "compliance fee" that balances appropriately the relevant administrative and fairness considerations. We also reiterate our proposals in previous letters[11] that RICs be permitted to use netting even when netting can be achieved only by carrying forward excess tax recoveries for some limited number of years.

## **V.** Items Related to RIC Modernization Act of 2010

The Institute seeks regulatory guidance necessary to properly implement the provisions of the RIC Modernization Act of 2010 (the RIC Modernization Act).[12]

First, we request guidance allowing a RIC to meet the RIC Modernization Act's requirement to provide its shareholders with a "written statement" regarding the character of its distributions by posting the information on its website and advising its shareholders, in writing, to consult the website for this information.[13] This guidance is of particular importance given the recent implementation of SEC Rule 30e-3, which permits RICs to deliver shareholder reports by making them publicly accessible

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[8] *See* Institute letters to Helen Hubbard, dated July 31, 2017 and January 16, 2018.

[9] The *Santander* decision involves joined cases C-338/11 to C-347/11. The decision was rendered in French and translated into the other languages of the European Union ("EU"). The decision can be found online in English and in French.

[10] The DFA Emerging Markets decision is cited in full as C-190/12 *Emerging Markets Series of DFA Investment Trust Company* (10 April 2014).

[11] *See* Institute letters to Robert Stack, Marjorie Rollinson, and Helen Hubbard, dated April 1, 2016 and to Marjorie Rollinson and Helen Hubbard, dated July 18, 2017.

[12] *See* Institute letter to Emily McMahon and William Wilkins, dated June 30, 2011.

[13] Section 301 of the Act.

on a website, free of charge, and sending investors a paper notice of each report's availability by mail.[14] RICs typically include the character of distributions in the annual reports sent to shareholders. As we expect that most funds will take advantage of the new SEC rule, RICs should be permitted to report distributions in publicly posted materials. Absent such guidance, RICs might be required to send a separate statement to shareholders for tax purposes. Such a requirement would be unnecessarily costly and burdensome.

Second, the Institute submitted a proposed Schedule D (Form 1120-RIC) to the IRS,[15] which would enable RICs to more accurately detail their capital gains and losses, rather than requiring a RIC to use the current generic form that applies to all corporations. As such, the proposed form would include information that is necessary to calculate a RIC's tax liability and would eliminate any information that is not. Specifically, the proposed Schedule D would eliminate the requirement for RICs to complete the Form 8949. The Institute also recommends that the IRS revise certain lines on the Form 1120-RIC to conform to changes implemented by the RIC Modernization Act.

## VI. Deemed Distributions under Section 305(c)

We request that the IRS and the Treasury Department address several issues of concern that were left open in the proposed regulations under section 305(c).[16] First, the Institute requests confirmation that deemed distributions under section 305(c) constitute qualified dividend income (assuming holding period requirements are met) and qualify for the dividends received deduction. Second, we request confirmation whether a change in method of accounting has occurred when a taxpayer (assuming the taxpayer has established a method) that has not been accounting for deemed distributions under section 305(c) on convertible securities begins to do so, and that the general principles governing voluntary method changes apply. We urge the IRS and the Treasury Department to consider all comments received and to finalize the regulations in a timely manner.

## VII. Cost Basis Reporting

The Institute continues to urge the IRS and Treasury Department to issue guidance clarifying several issues with respect to cost basis reporting. Specifically, we ask the IRS and Treasury Department to

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[14] *Final Rule: Optional Internet Availability of Investment Company Shareholder Reports*, SEC Rel. Nos. 33-10506, 34-83380, IC-33115 (June 5, 2018), *available at* https://www.sec.gov/rules/final/2018/33-10506.pdf. Investors who prefer to receive the full reports in paper may, at any time, choose that option free of charge. RICs may apply the new "notice and access" method beginning no earlier than January 1, 2021.

[15] *See* letter to John Koskinen and William Wilkins dated March 13, 2014.

[16] *See* letter to Erik Corwin dated December 15, 2014 from the Institute, the Managed Funds Association, and the Securities Industry and Financial Markets Association, and the Institute's letter to William Wilkens and Tom West, dated July 20, 2016.

adopt in final regulations the rules provided in Notice 2011-56[17] regarding changes from a broker's default method of average cost, with the few modifications detailed in our previous letter. [18]

We also urge the IRS and Treasury Department to reconsider the requirement that a shareholder who elects to use the average cost method, revokes such election, or changes from the average cost method (whether the broker default or a shareholder election) must do so in writing. Requiring such elections, revocations, and changes in writing is unnecessarily burdensome and potentially costly for shareholders.[19] The Institute instead proposes that the regulations permit brokers, including RICs, to provide a written confirmation to shareholders of a cost basis method election, revocation, or change, in lieu of a written notification by the shareholder.

The Institute also requests that several other issues regarding cost basis reporting be clarified. First, the IRS and Treasury Department should clarify that brokers may use any basis method as their default method for mutual fund shares, including first-in, first-out (FIFO), average cost, or any other formulaic method, as clearly intended by Congress. Second, we request that gifted shares have a carryover holding period, even if the shares were gifted at a loss (*i.e.*, the cost basis of the gifted shares exceeds the fair market value on the date of gift) and the donee subsequently sells the shares at a loss. Third, we ask the IRS and Treasury Department to clarify that, for cost basis reporting purposes, shares acquired by an estate after the decedent's death have a basis equal to the fair market value on the date of acquisition, unless the broker receives other information from an estate representative. Finally, the IRS should (i) clarify whether RIC liquidating distributions are subject to cost basis reporting and; (ii) if so, amend Forms 1099-B and 1099-DIV, and the accompanying instructions, to specify that liquidating distributions by RICs should be reported on Form 1099-B, so that brokers can properly report cost basis information for such distributions.

## VIII. Foreign Bank and Financial Account Reporting

The Institute urges that the proposed revisions[20] to the Report of Foreign Bank and Financial Accounts (FBAR)[21] filing requirements be modified to resolve ongoing difficulties for the fund industry. In light of the many issues raised with respect to FBAR, we encourage the government to conduct a comprehensive review of the FBAR reporting requirements to eliminate unnecessary filings that do not

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[17] 2011-29 I.R.B. 54.

[18] *See* Institute letter to Emily McMahon and William Wilkins, dated July 28, 2011.

[19] *See* Institute letter to William Wilkins, dated February 8, 2010. This letter commented on the proposed in-writing requirement for an affirmative average cost election. The proposed regulations did not require a revocation of such an election or a change from average cost to be in writing, so the Institute's letter does not address these rules, which were added to the final regulations.

[20] 81 Fed. Reg. 12614 (March 10, 2016).

[21] FinCEN Report 114.

have the "high degree of usefulness in criminal, tax, regulatory, and counterterrorism matters" required by the Bank Secrecy Act.[22]

The concerns expressed in the Institute's letter[23] relate to the likelihood that FinCEN will be overwhelmed by essentially worthless FBAR filings unless three different areas are addressed. Specifically, amendments are needed to prevent counterproductive FBAR filings by (1) persons employed by fund managers, (2) individuals with signature authority over 25 or more foreign accounts, and (3) both a fund and its US global custodian with respect to the same account. Our requested guidance is consistent with FBAR's purposes of thwarting abusive tax schemes and combatting terrorism; adopting our suggestions will lead to improved compliance.

## IX. Ownership Tracking Requirements

The Institute asks that a project be opened to amend the regulations under sections 382 and 383 with respect to ownership tracking requirements that apply to participant-directed retirement accounts holding RIC shares. Specifically, the regulations should permit a RIC to look through participant-directed retirement accounts and treat each participant/investor who holds less than five percent of the RIC's shares as part of the RIC's direct public group. The concerns addressed by sections 382 and 383 are not implicated when a RIC's new shareholders are retirement accounts that cannot benefit from such tax attributes.

This change effectively would prevent a large collection of small investors making independent investment decisions from being treated as a single entity for ownership change purposes. Absent this change, a retirement plan administrator's decision as to which RICs to offer in a plan could significantly affect whether other shareholders in the RIC can benefit from the RIC's capital losses even though the retirement plan administrator is neither a beneficial owner of RIC shares nor responsible for allocating investment assets among RICs. This scenario should not raise tax policy concerns.

## X. Electronic Filing

The Institute recommends that a project be opened to implement electronic filing of Forms 1120-RIC. Specifically, we suggest that the Modernized e-File (MeF) system be updated to process Forms 1120-RIC. Electronic filing reduces tax compliance burdens on taxpayers, especially with respect to bulky corporate returns such at the 1120-RIC.

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[22] 31 U.S.C. 5311.

[23] *See* Institute letter to Jennifer Shasky Calvery, dated May 9, 2016.

XI. Money Market Fund Reform

The IRS and Treasury Department have addressed most of the issues arising from money market reform. In addition to the QII issue discussed above, we request guidance on two remaining issues.[24] First, we ask the IRS and Treasury to provide guidance on how funds should treat any liquidity fees received. Second, the government should clarify whether the distribution of excess liquidity fees results in a return of capital or if the fund is deemed to have sufficient earnings and profits to support such distribution.

XII. FATCA

The Institute strongly supports FATCA's tax compliance objectives and encourages the continued refinement of administrable rules that implement, consistent with Congressional intent, the Chapter 4 reporting and withholding regime. Consistent with prior submissions, the Institute recommends that the IRS and Treasury Department (1) clarify the Form 1042-S coding for long-term capital gain dividends, (2) improve the interaction of Forms 1042-S and W-8, and (3) smooth the transition to the new W-8 series forms.[25] As FATCA's phased implementation is well underway, the Institute recommends giving FATCA issues continued high priority.

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If we can provide you with any additional information regarding these issues, please contact Keith Lawson (202-326-5832 or lawson@ici.org), Karen Gibian (202-371-5431 or kgibian@ici.org) or me (202-326-5826 or katie.sunderland@ici.org).

Sincerely,

Katie Sunderland
Counsel – Tax Law

cc: Notice.comments@irscounsel.treas.gov
Scott Dinwiddie
Chip Harter
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[24] *See* Institute letter to Michael Novey and Helen Hubbard, dated September 8, 2016.

[25] *See* Institute's Submission for July 27, 2016 IRS FATCA Roundtable, dated July 13, 2016.

Michael Novey
Doug Poms
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## Enclosure A: Additional Recommendations for the 2018-2019 Guidance Priority List

### I. Issues on the 2017-2018 Guidance Priority List

The Institute requests that the IRS and Treasury Department issue guidance on the following items currently on the 2017-2018 Guidance Priority List.

#### A. Check-the-Box Election

The Institute asks the IRS and Treasury Department to issue guidance to coordinate the entity classification election under the check-the-box regulations[26] with the RIC election under section 851(b)(1). Specifically, we request that an eligible entity electing to be treated as a RIC will be deemed to have elected to be classified as an association taxable as a corporation, effective as of the first day the entity is treated as a RIC.[27] The regulations already provide such a deemed check-the-box election for entities that elect to be treated as Real Estate Investment Trusts (REITs), for certain entities claiming tax-exempt status, and for entities electing to be taxable as S corporations. Amending the regulations to similarly coordinate the RIC election with the check-the-box rules will reduce administrative burdens for affected entities and the IRS and provide certainty as to an entity's status.

#### B. PFICs

We ask the IRS and the Treasury Department to issue additional guidance regarding passive foreign investment companies (PFICs). The preamble to the final PFIC mark-to-market regulations[28] notes in three places that comments received relating to the impact of the PFIC rules on RICs were beyond the scope of that regulations project.[29] We request that a regulations project be opened to address these and other PFIC-related issues faced by the industry.

Specifically, the Institute requests guidance providing (i) that gains from dispositions of former PFIC stock are capital while losses are ordinary to the extent of prior unreversed inclusions; (ii) RICs with automatic consent to terminate a section 1296 election during a non-PFIC year; (iii) that RICs may recognize any change in PFIC status of a foreign corporation for the RIC's taxable year within which the taxable year of the foreign corporation ends; (iv) that the consequences to RICs of applying former Prop. Treas. Reg. § 1.1291-8 will be respected, where relevant, for purposes of section 1296; and (v) that RICs may determine qualified electing fund (QEF) inclusions using audited financial statements that

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[26] Treas. Regs. § 301.7701-3.

[27] *See* Institute letter to Emily McMahon and William Wilkins, dated June 1, 2011.

[28] T.D. 9123, published on April 29, 2004.

[29] *See* Institute letter, dated November 22, 2002, and Institute letter to Dale Collinson, dated April 24, 2003.

were prepared using U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting standards, and that all QEF inclusions subject to this election will be treated as ordinary, but retain the capital character of disposition gains and losses.

### C. Guidance on Income and Asset Diversification

The Institute recommends that the IRS and Treasury Department provide guidance regarding the application of the "cure" provisions in Code Sections 851(d)(2) and (i), added by the Regulated Investment Company Modernization Act,[30] including the schedules referred to in Sections 851(d)(2)(A)(i) and (i)(1)(A) and the meaning of "due to reasonable cause and not due to willful neglect" in Sections 851(d)(2)(A)(ii) and (i)(1)(B). Specifically, the Institute requests that the IRS provide guidance allowing RICs to rely on the REIT regulations[31] for purposes of the RIC income test. The Institute also requests that the IRS provide guidance regarding the asset diversification cure provisions for RICs.

### D. Section 529 Qualified Tuition Programs

The Institute commends the IRS and Treasury Department for issuing timely guidance that provides transition relief for section 529 qualified tuition programs (section 529 plans) with respect to changes made by the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act). The PATH Act allows beneficiaries of a section 529 plan to recontribute refunded amounts to a section 529 plan, up to the refunded amount, without incurring income inclusion or penalties, provided the amount is recontributed within 60 days of the date of the refund. We request guidance on how a "recontribution" should be characterized as the industry is currently approaching recontributions in an inconsistent manner.[32]

In addition, a project to address section 529 plan issues, which was included on prior Guidance Priority Lists, was deleted from the 2009-2010 list without guidance being issued. Guidance regarding section 529 plans remains necessary to implement fully the Advance Notice of Proposed Rulemaking ("Advance Notice") regarding section 529 plans that the IRS released in 2008. We are pleased that the Advance Notice reflects several comments previously submitted jointly by the Institute and the Securities Industry and Financial Markets Association ("SIFMA").[33] It remains important, for those

[30] Pub. L. No. 111-325, 124 Stat. 3537. The Institute previously has asked for additional guidance implementing the RIC Modernization Act.

[31] Specifically, Treas. Reg. § 1.856-7, which provides guidance regarding a REIT's failure to meet its gross income requirements.

[32] *See* Institute letter to Victoria Judson and Janine Cook, dated January 24, 2017.

[33] *See* Institute and SIFMA letter to Michael Desmond, dated June 12, 2007.

saving for education through section 529 plans, that the tax treatment of investments in such plans is clear. We urge the IRS to continue its work on this guidance project to address outstanding issues.[34]

## II. Issues on Previous Years' Priority Guidance Lists

The Institute requests that the IRS and Treasury Department issue guidance on the following items that were on previous years' Priority Guidance Lists but were removed from the 2017-2018 Priority Guidance List.

### A. Prepaid Forward Contracts

We urge guidance on prepaid forward contracts.[35] Specifically, the Institute strongly supports prompt and comprehensive guidance regarding the tax treatment of exchange-traded notes (ETNs). Although ETNs can provide important investment opportunities, they also take advantage of gaps in the tax law to provide investors with tax deferral (of up to 30 years) and character conversion that is inappropriate. This treatment is far more favorable than the treatment obtained by investors in comparable financial instruments and provides a tax incentive to take on issuer credit risk, rather than invest in products that do not entail this risk. In the absence of legislation, regulations should be issued under the Treasury Department's existing authority under section 1260 and should provide a mark-to-market election. If a comprehensive regulatory approach is not developed under section 1260, guidance should be issued under section 446 to address any ETNs that remain outside the scope of the section 1260 constructive ownership solution.

### B. Notional Principal Contracts

The Institute remains very interested in guidance providing simplicity and certainty regarding the taxation of notional principal contracts. The Institute made a number of recommendations in our letters on the regulations proposed in 2004 and 2011.[36] We recommend that marks under the elective mark-to-market method, as well as value payments under the noncontingent swap method, be treated as resulting in capital gain or loss. We also suggest that credit default swaps and certain short-term swaps be excluded from the modified noncontingent swap method and the mark-to-market election. Further, we request additional guidance regarding the definition of "payment" and on several technical issues. Finally, we suggest that the guidance should be made entirely prospective upon promulgation of final regulations.

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[34] *See* Institute letter to Richard Hurst, Mary Berman and Monice Rosenbaum, dated May 12, 2008, for comments regarding the Advance Notice.

[35] *See* Institute letter to Eric Solomon and Donald Korb, dated May 13, 2008. *See also*, Testimony of William M. Paul on behalf of the Institute, presented on March 5, 2008, before the House of Representatives Ways and Means Subcommittee on Select Revenue Measures.

[36] *See* Institute letter to Greg Jenner and Donald Korb, dated July 21, 2004, and Institute letter to Emily McMahon and William Wilkins, dated December 15, 2011.

C. Distressed Debt

The Institute requests guidance addressing the accrual of interest on distressed debt. Investors have long faced uncertainty regarding how the existing original issue discount and market discount rules should apply to severely distressed, and speculative, debt. In other cases, application of these rules creates what many believe to be inappropriate results.[37] These issues have been exacerbated by the events of the financial crisis.[38]

## III. Other Issues Directly Affecting RICs and Their Shareholders

The Institute requests that the IRS and Treasury Department address issues arising from the application of the general corporate tax rules to RICs. These rules can be unnecessarily difficult to apply and can result in unintended consequences.

A. Business Continuity Requirement for Tax-Free Mergers

First, the Institute requests guidance clarifying the application of the "business continuity" requirement to RICs under section 368 and Treas. Reg. § 1.368-1(d)(2).[39] This clarification is necessary because it is difficult to discern the intended scope of the business continuity test as applied to RIC reorganizations. As a result, many RICs engaging in merger transactions are compelled to rely on the "asset continuity" test;[40] this test, to the detriment of the RIC's shareholders, can place artificial limits on the ability of a portfolio manager to dispose of portfolio securities acquired from a target RIC and imposes significant compliance burdens on funds. The Institute requested guidance on this issue in 2004, at which point the IRS informed us that they wished to gather more information on RIC mergers through the private letter ruling process. The Institute hopes that the IRS and Treasury Department now have sufficient information to open a project on this issue and requests that they do so.

B. RIC Investments in Partnerships with Different Taxable Year-Ends

Second, we request guidance regarding RIC investments in a partnership in which the RICs and the partnership have different tax years; this guidance should allow RICs to take partnership items into income at the end of each month, rather than at year-end. In general, partners must take partnership

[37] *See*, *e.g.*, Letter of May 15, 1991, from Jere D. McGaffey to Fred T. Goldberg, Jr. (transmitting comments prepared by members of the ABA's Section of Taxation on the application of market discount rules to speculative bonds).

[38] *See, e.g.*, Institute letter to Eric Solomon and Donald Korb, dated July 28, 2008.

[39] *See* Institute letter to William D. Alexander and Lon B. Smith, dated January 15, 2003. *See also* Institute letter to William D. Alexander, dated April 30, 2004.

[40] *See* Treas. Reg. § 1.368-1(d)(3).

items into account at the end of the partnership's tax year.[41] If a RIC invests in a partnership with a different tax year, however, this can cause mismatches between the RIC's distributions and the amount of earnings and profits associated with the partnership's income.

C. Taxable Mortgage Pools

Third, we request regulatory guidance to clarify issues relating to excess inclusion income of a REIT that is a taxable mortgage pool (TMP) or that has a qualified REIT subsidiary that is a TMP. Although Notice 2006-97[42] addressed a few issues, and responded to some of the Institute's concerns regarding the lack of guidance in this area,[43] many critically important issues remain unresolved. At a minimum, and as requested by the Institute in 2006, guidance should be issued stating that Notice 2006-97 will not be applied until some reasonable period after a practical reporting regime is implemented and the many uncertainties arising from the Notice are resolved.[44]

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[41] *See* Rev. Rul. 94-40, 1994-1C.B. 274 (for purposes of the required distribution under section 4982, a RIC must take into account its share of partnership items of income, gain, loss, and deduction as they are taken into account by the partnership, regardless of the taxable years of the RIC and the partnership in which the RIC is a partner).

[42] 2006-2 C.B. 904.

[43] *See* Institute letter to Eric Solomon and Donald Korb dated May 12, 2006.

[44] *See* Institute letter to Lon Smith, dated December 29, 2006.