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By Electronic Delivery

December 9, 2022

Tom West
Deputy Assistant Secretary (Tax Policy)
US Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

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

RE: Application of Inflation Reduction Act Tax Provisions to Certain Registered Funds

Dear Mr. West and Mr. Paul:

The Investment Company Institute[1] asks the Treasury Department and the Internal Revenue Service (IRS) to provide regulatory relief exempting certain registered investment funds from the tax provisions enacted by the Inflation Reduction Act of 2022 (the "Act"). Specifically, the new corporate minimum tax and the excise tax on the repurchase of corporate stock provide exceptions for all funds registered under the Investment Company Act of 1940 (the "1940 Act") that also are regulated investment companies (RICs) under the Internal Revenue Code. Our request, therefore, is limited to those 1940 Act registered funds that are not RICs for tax purposes (hereinafter referred to as "non-RIC funds").

An exception to these provisions for RICs is warranted because of their organizational structure and operation and the applicable securities laws and accounting standards. That rationale applies equally to these non-RIC funds. Absent such an exemption, application of the corporate minimum tax and the excise tax on stock repurchases to non-RIC funds will have adverse consequences on fund investors.

We thus ask the Treasury Department and the IRS to clarify that these non-RIC funds (1) are not "applicable corporations" for purposes of the corporate minimum tax, and (2) are not subject to the excise tax on corporate stock repurchases. The Act provides ample regulatory authority to the Treasury Department and the IRS to correct these oversights. We understand there are relatively few non-RIC funds, so this guidance would have very limited effect. The lack of such

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[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of $27.8 trillion in the United States, serving more than 100 million investors, and an additional $7.4 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

guidance, however, would impact significantly the investors in these funds, many of whom are retail investors saving for retirement and other needs.

Background

Registered Funds

Registered funds, which are quite different from traditional operating companies, are pooled vehicles that provide diversified investments to retail and institutional investors. These funds are governed by a board of directors or trustees and managed by third parties; they do not have employees of their own.

There are four main types of registered funds: mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs).[2] These funds provide different mechanisms, as discussed in the appendix, by which investors acquire and dispose of their interests in the funds.

All funds that register with the Securities and Exchange Commission (SEC) under the 1940 Act are highly regulated. The 1940 Act and the rules thereunder govern the structure and operations of investment companies through a combination of registration and disclosure requirements and restrictions on day-to-day operations. Among other things, the 1940 Act addresses capital structures, custody of assets, investment activities, and the duties of fund boards. The fund industry also is subject to the Investment Advisors Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933.

Taxation of RICs

To qualify as a RIC under Subchapter M of the Internal Revenue Code, a corporation must be registered under the 1940 Act and must satisfy certain income and asset tests.[3] These qualification tests include strict limits on a RIC's income and assets and apply in addition to any income and asset requirements under the 1940 Act.

One of the benefits of a RIC as an investment vehicle is that it pays little or no tax at the corporate level if it satisfies the Subchapter M qualification tests and certain distribution

[2] For additional information about the types of funds and the industry overall, *see* 2022 Investment Company Fact Book, which can be found at: https://www.icifactbook.org/.

[3] Section 851. At least 90 percent of a RIC's gross income must be derived from certain sources, including dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock, securities, or foreign currencies. In addition, at the close of each quarter of the RIC's taxable year, at least 50 percent of the value of the RIC's total net assets must consist of cash, cash items, government securities, securities of other funds, and investments in other securities that, with respect to any one issuer, represent neither more than 5 percent of the assets of the RIC nor more than 10 percent of the voting securities of the issuer. Further, no more than 25 percent of the RIC's assets may be invested in the securities of any one issuer (other than government securities or the securities of other RICs), the securities (other than the securities of other RICs) of two or more issuers that the RIC controls and that are engaged in similar trades or businesses, or the securities of one or more qualified publicly traded partnerships.

requirements under section 852. Because RICs can deduct from taxable income the dividends paid to investors,[4] all tax is paid at the investor level. Subchapter M, and the dividends paid deduction, effectively provide fund investors with tax treatment comparable to that of direct investors in securities. Various distribution requirements applicable to RICs ensure that essentially all of a RIC's taxable income and gains are distributed to investors during the calendar year in which these amounts are earned.[5]

Non-RIC Funds

Although most 1940 Act-registered funds are RICs for tax purposes, there are some funds that do not qualify under Subchapter M because their investments do not meet the qualification tests. Many of these funds are closed-end funds or ETFs that invest in master limited partnerships, exceeding the 25% limitation on investment in publicly traded partnerships.[6] Funds that are registered under the 1940 Act that are not RICs are not eligible to deduct the dividends paid to investors and are taxed instead under the general corporate tax rules.

New Corporate Minimum Tax

The Act imposes a new 15% minimum tax on the "adjusted financial statement income" (as defined under new section 56A) of certain large corporations. These corporations would pay the larger of the minimum tax or the regular tax. The minimum tax generally is applicable to corporations with over $1 billion in annual adjusted financial statement income for any three consecutive taxable years preceding the tax year. The new minimum tax is effective for taxable years beginning after December 31, 2022. An applicable corporation for this purpose specifically excludes RICs, real estate investment trusts (REITs), and S corporations.

The purpose of the corporate minimum tax is to ensure that corporations with significant book income do not avoid paying their fair share of tax. Although they are not the target of this provision, investment companies that are registered under the 1940 Act require an exemption to prevent their unrealized gains from being subject to the minimum tax.

The unique issue for 1940 Act-registered funds arises from the Generally Accepted Accounting Principles (GAAP) requirement to report investments on financial statements at fair market value rather than historical cost.[7] Unlike other corporations, the financial statements of all registered

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[4] The dividends paid deduction (DPD) is provided under section 561.

[5] Section 852(a) requires a RIC to distribute at least 90 percent of its income and gains for its fiscal year, generating a DPD for those amounts, to qualify as a RIC under Subchapter M. Any amount retained by the RIC above the 90 percent will be subject to a RIC-level tax. RICs also are subject to a 4 percent excise tax under section 4982 if they do not distribute annually 98 percent of their ordinary income (measured on a calendar year basis) and 98.2 percent of their capital gains (measured through October 31), plus any amounts not distributed in the prior calendar year. The net effect of these requirements is that RICs generally distribute substantially all their income and gains each year.

[6] For a more detailed description of closed-end funds and ETFs, *see* Appendix.

[7] *See e.g.,* Financial Accounting Standards Board, *Accounting Standards Codification*, Topic 946-45-6.

funds (whether or not they qualify as RICs) include unrealized gains on marketable securities as income. Taxing unrealized gains clearly was not the provision's purpose. While the exemption for RICs prevents them from this potential and unintended tax, the exemption does not apply to those 1940 Act funds that cannot qualify as RICs.

Section 59(k) defines "applicable corporation" for purposes of the alternative minimum tax. Section 59(k)(1) specifically excludes RICs from this definition. Non-RIC funds, however, still could be subject to the minimum tax if they otherwise satisfy the $1 billion threshold because their adjusted financial statement income could be higher due to the unrealized gains recognized for book purposes.

Section 59(k)(3) provides general regulatory authority to the Secretary to provide regulations and other guidance for the purposes of carrying out the corporate minimum tax provisions. We ask the Treasury Department and the IRS to exercise this authority, by exempting non-RIC funds from the definition of "applicable corporation," and thereby preventing unintended consequences that would harm fund investors.

New Excise Tax on Stock Buybacks

Section 10201 of the Act added to the Internal Revenue Code new section 4501, Repurchase of Corporate Stock. This provision imposes on each "covered corporation" a tax equal to one percent of the fair market value of any stock of the corporation that is repurchased by the corporation during the taxable year, if the total value of the stock repurchased exceeds $1,000,000. A "covered corporation" generally includes any corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)). New section 4501(e)(5) provides an exception to the excise tax for repurchases by a RIC (as defined in section 851) or a REIT. This provision is effective for transactions occurring after December 31, 2022.

The original sponsors of this legislation have stated that its purpose is to tax corporations that use savings from the 2017 corporate tax rate cut to buy back shares of their own stock, further enriching executives and wealthy shareholders, rather than investing in workers or communities. Investment companies, including non-RIC funds, are not operating companies and do not have employees. Although non-RIC funds may have benefited from the corporate rate tax cuts, the sole purpose of these investment vehicles is to provide a return to investors.

Non-RIC funds, like RICs, redeem and repurchase their shares in routine transactions. Redemption of shares by authorized participants are a crucial factor in the proper functioning of ETFs and help maintain parity between the trading price of an ETF on the secondary market and the net asset value (NAV) of the fund. Closed-end funds often repurchase shares for this same reason. Also, many closed-end fund repurchases of preferred shares are scheduled in advance; imposing an excise tax on these transactions fundamentally would change the shareholders' investment. These funds are not "abusing" the tax laws; rather, they are engaged in routine redemption and repurchase activities. The excise tax ultimately would be borne by the funds' shareholders, many of whom are moderate-income investors saving for retirement, education, or other important needs.

Like RICs, non-RIC funds should not be subject to the excise tax on stock buybacks. We thus ask the Treasury Department and the IRS to issue guidance providing that funds registered under the 1940 Act that are not RICs similarly are exempt from this provision. We note that Section 4501(f) provides authority to the Secretary to provide regulations and other guidance as necessary and appropriate to carry out this provision, including, among other things, guidance needed to address special classes of stock and preferred stock. We believe that this provision gives the government the authority to grant directed relief to non-RIC funds.

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We appreciate your prompt attention to our request. We will contact your offices to discuss the matter further, but please do not hesitate to reach out to me (202/371-5432 or kgibian@ici.org) if you have additional questions or concerns.

Sincerely,

Karen Lau Gibian
Associate General Counsel, Tax Law

cc: Krishna Vallabhaneni
Brett York
Michael Novey
Robert Wellen
Helen Hubbard

APPENDIX

Closed-End Funds

A closed-end fund is a type of investment company the shares of which are listed on a stock exchange or traded in the over-the-counter market. The assets of a closed-end fund are professionally managed in accordance with the fund's investment objectives and policies and may be invested in equities, bonds, and other securities. The market price of a closed-end fund share fluctuates like that of other publicly traded securities and is determined by supply and demand in the marketplace.

A closed-end fund is created by issuing a fixed number of common shares to investors during an initial public offering. Subsequent issuance of common shares can occur through secondary or follow-on offerings, at-the-market offerings, rights offerings, or dividend reinvestments. Closed-end funds also are permitted to issue one class of preferred shares in addition to common shares.

Holders of preferred shares are paid dividends but do not participate in the gains and losses on the fund's investments. Issuing preferred shares allows a closed-end fund to raise additional capital, which it can use to purchase more securities for its portfolio. Once issued, shares of a closed-end fund generally are bought and sold by investors in the open market and are not purchased or redeemed directly by the fund, although some closed-end funds may adopt stock repurchase programs or periodically tender for shares.

Because a closed-end fund does not need to maintain cash reserves or sell securities to meet redemptions, the fund has the flexibility to invest in less-liquid portfolio securities. For example, a closed-end fund may invest in securities of very small companies, municipal bonds that are not widely traded, or securities traded in countries that do not have fully developed securities markets.

Exchange Traded Funds

An ETF is similar to a mutual fund in that it offers investors a proportionate share in a pool of stocks, bonds, and other assets such as derivatives or bank loans. Like a mutual fund, an ETF is required to post the mark-to-market NAV of its portfolio at the end of each trading day and must conform to the main investor protection mechanisms of the 1940 Act, including limitations on leverage, daily valuation and liquidity requirements, prohibitions on transactions with affiliates, and rigorous disclosure obligations. Also, like mutual funds, creations and redemptions of ETF shares are aggregated and executed just once per day at NAV.

Despite these similarities, key features differentiate ETFs from mutual funds. One major difference is that retail investors buy and sell ETF shares on the secondary market through a broker-dealer, much as they would any other type of stock. In contrast, mutual fund shares are not listed on stock exchanges but are purchased and sold through a variety of distribution channels, including through investment professionals or directly from a fund company or discount broker.

Pricing also differs between mutual funds and ETFs. Mutual funds are "forward priced," meaning that, although investors can place orders to buy or sell mutual fund shares throughout the day, all orders placed during the day will receive the same price – the NAV – the next time it is computed. Most mutual funds calculate their NAV as of 4:00 p.m. eastern time because that is when US stock exchanges typically close. In contrast, the market price of an ETF share is continuously determined on a stock exchange. Consequently, the price at which investors buy and sell ETF shares on the secondary market may not necessarily equal the NAV of the portfolio of securities in the ETF. Two investors selling the same ETF shares at different times on the same day may receive different prices for their shares, both of which may differ from the ETF's NAV, which, like a mutual fund, generally is calculated as of 4:00 p.m. eastern time.

Authorized Participants (APs) are critical to an ETF's efficient operation. First, APs are the only parties (other than the ETF itself) involved in the creation or redemption of ETF shares. APs contribute securities to the ETF, in the form of "creation baskets," for a fixed number of ETF shares that the AP then sells on the exchange. APs also can redeem the same number of ETF shares and receive an equal-valued basket of the ETF's portfolio securities and/or cash.

Second, APs, along with other market participants such as market makers and proprietary trading firms, perform the critical arbitrage function that benefits all investors, including those holding ETF shares in retirement accounts. Specifically, these market participants (which can include APs) buy ETF shares on the secondary market when the ETF's market price falls below its NAV and then redeem the ETF shares through APs. These redemptions are necessary to ensure that retail investors selling their ETF shares in the secondary market receive a price close to the NAV when those shares are sold. This arbitrage function, which requires the repurchase of shares by the ETF, is a critical and essential element of the commercial success of ETFs. It allows the markets to ensure adequate liquidity and transparent price discovery on a continuous basis.