Mutual Fund Directors Forum

Tax developments and hot topics for mutual fund directors

February 16, 2023

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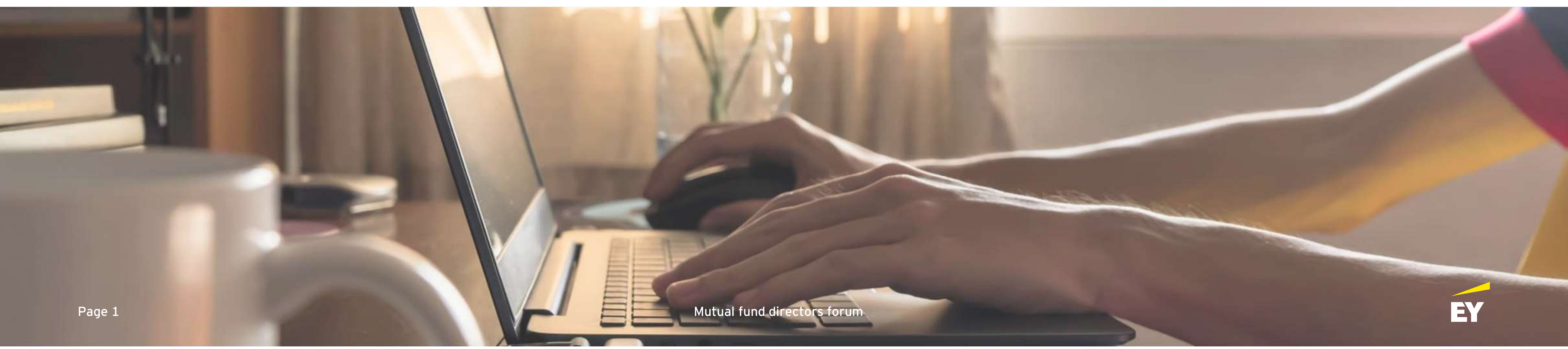

Today's presenters

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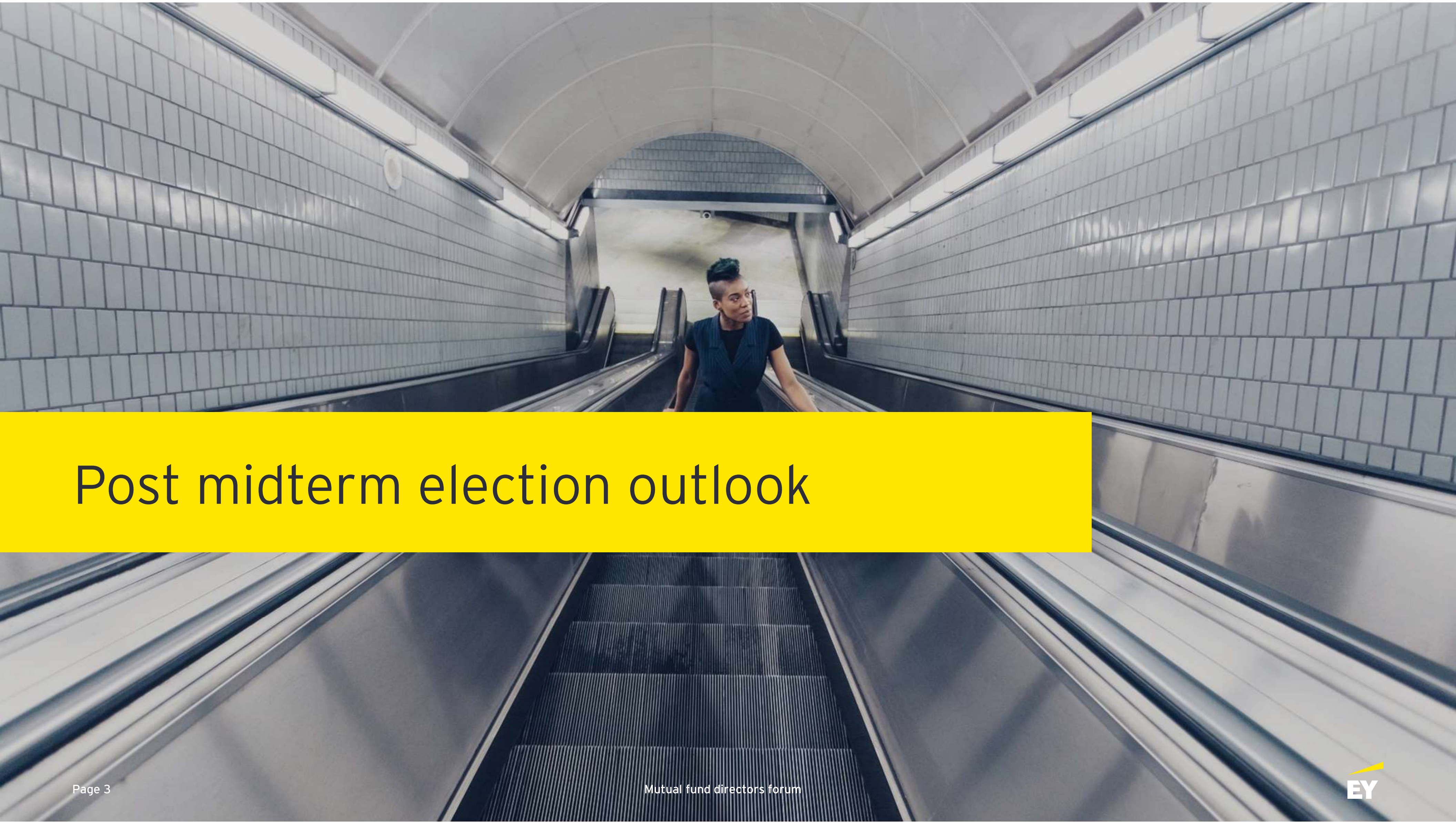
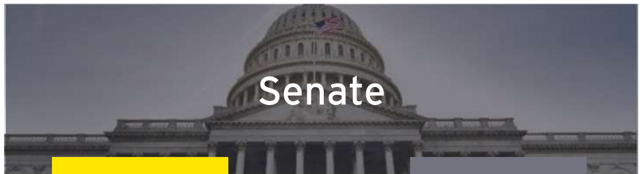
Post midterm election outlook

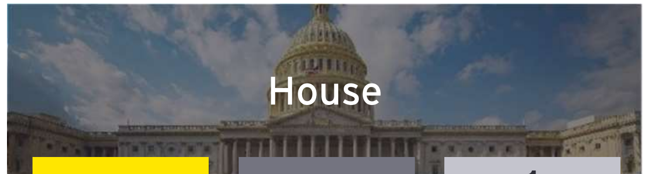


Congressional dashboard: ratios and leadership



51
Democrats & Independents

49
Republicans



212
Democrats

222
Republicans

1
Vacancy – VA
Feb. 21 special election

Senate Democrats	
Majority Leader	Chuck Schumer (D-NY)
Whip	Dick Durbin (D-IL)
Policy & Communications Committee Chair	Debbie Stabenow (D-MI)
Steering Committee Chair	Amy Klobuchar (D-MN)
President Pro Tempore	Patty Murray (D-WA)

Senate Republicans	
Minority Leader	Mitch McConnell (R-KY)
Whip	John Thune (R-SD)
Conference Chair	John Barrasso (R-WY)
Policy Committee Chair	Joni Ernst (R-IA)

House Republicans	
Speaker	Kevin McCarthy (R-CA)
Majority Leader	Steve Scalise (R-LA)
Whip	Tom Emmer (R-MN)
Conference Chair	Elise Stefanik (R-NY)

House Democrats	
Minority Leader	Hakeem Jeffries (D-NY)
Whip	Katherine Clark (D-MA)
Caucus Chair	Pete Aguilar (D-CA)
Assistant Leader	Jim Clyburn (D-SC)

Key dates

January 19
- US hit the debt limit

February 7
- State of the Union Address

March 1-3
- House Democratic retreat

March 19-21
- House Republican retreat (Orlando)

Early June
- Earliest date debt limit extraordinary measures exhausted, Treasury says

September 30

Expiration of:
- Government funding
- Farm bill
- Airport & Airway Trust Fund excise taxes

Year-end omnibus – Consolidated Appropriations Act, 2023

What was in?

- **Health** provisions on telehealth, Medicare physician payments and extenders, Medicaid, mental health, FDA
- SECURE 2.0 **retirement** package on catch-up contributions, required distributions, emergency accounts, penalty relief
- Syndicated **conservation easement** limits
- **Electoral Count Act** to reform how Congress identifies electors, VP role is ministerial (with no power to accept or reject electors)
- $45b in aid to **Ukraine**
- **Workplace rights** for mothers, mothers-to-be

What was left out?

- **Tax** provisions like relief from the Section 174 R&D amortization requirement, modifications to Section 163(j), tax extenders, or an expanded Child Tax Credit (CTC)
- An increase in or suspension of the **debt limit**
- **Energy permitting** reforms
- **Immigration** provisions, including citizenship proposals for farm workers
- **Banking** access for cannabis companies
- Relief from $600 **third-party network transactions reporting** threshold in American Rescue Plan Act (though IRS later delayed)

Much of the House business for 2023 falls into two categories

Oversight investigations

- The southern border, the Administration's handling of border flows
- The business dealings of President Biden's son
- COVID-19, the role of Dr. Fauci
- US withdrawal from Afghanistan
- "Weaponization" of federal government
  - Including probes of Big Tech companies
- Companies' environmental, social and governance (ESG) initiatives

Fiscal deadlines

Debt limit – currently forecast to need congressional action no sooner than 3Q 2023

Government funding – runs out 9/30/23 after year-end 2022 bill criticized by GOP

Looking back to a decade ago, when GOP concerns forced tough negotiations on the issues:

August 2011

Tea Party concerns about the debt limit resulted in the Budget Control Act, which:

- increased the debt limit by $900b and cut spending by a similar amount
- established the failed Supercommittee effort to reduce spending
- set "sequestration" fallback spending caps that Congress routinely raised

October 2013

A 16-day government shutdown resulted from an appropriations impasse due to some Republicans insisting that a CR include language delaying or defunding the Affordable Care Act

Debt limit

Democratic perspectives

- White House: won't negotiate on debt limit
- Treasury Sec. Yellen: prioritization plan won't work
  - "Treasury systems have all been built to pay our bills, to pay all of our bills when they are due and on time and not to prioritize one form of spending over another." – January 20
- Members like House Budget Committee Ranking Member Boyle have discussed discharge petition

Bipartisan approach?

- President Biden said he intends to meet with Speaker McCarthy on the issue
- Senators Manchin and Romney proposed "rescue committee" to examine approaches to entitlement, other spending

Republican perspectives

- Speaker McCarthy: need spending caps deal like those that accompanied debt limit suspensions in 2018-19
  - During the era when Budget Control Act spending limits capped discretionary spending
- Some conservatives are seeking to advance prioritization plan to instruct Treasury what bills to pay
  - Entitlements, veterans' benefits, military spending likely to be prioritized

Extraordinary measures used by Treasury in the past include:

- Suspending new issuances of State and Local Government Series securities
- Suspending investments in the Exchange Stabilization Fund

Extraordinary measures used by Treasury now:

- Redeeming existing, and suspending new, investments of the Civil Service Retirement and Disability Fund (CSRDF) and the Postal Service Retiree Health Benefits Fund (Postal Fund)
- Suspending reinvestment of the Government Securities Investment Fund (G Fund) of the Federal Employees Retirement System Thrift Savings Plan

Potential additional extraordinary measures:

- Exchanging Federal Financing Bank debt for other debt that doesn't count against the limit

Ways and Means Chairman Jason Smith's stated priorities

IRS funding, oversight

"Questions about the leaking of sensitive taxpayer information and an agency with a history of targeting conservative Americans

Tax benefits for corporations

"[Questioning] showering tax benefits on corporations that have shed their American identity in favor of a relationship with [other nations]

Utilizing the tax code

"Build on the success of the [TCJA to] reward working families with a tax code that delivers better jobs, higher wages, and more investment

American workers

"Prioritizing American workers

Domestic energy production

"Encourage domestic energy production and achieve energy independence through the tax code instead of using it as a tool to punish energy producers

Strengthening supply chains

"Using both trade policy and our tax code to re-shore and strengthen our supply chains, where products and services vital to our national security are made here at home

Republicans will have 25 seats; Democrats will have 18 seats

New members:

- Rep. Mike Carey (OH)
- Rep. Randy Feenstra (IA)
- Rep. Michelle Fischbach (MN)
- Rep. Brian Fitzpatrick (PA), co-chair of the bipartisan Problem Solvers Caucus
- Rep. Nicole Malliotakis (NY)
- Rep. Blake Moore (UT)
- Rep. Michelle Steel (CA)
- Rep. Greg Steube (FL)
- Rep. Claudia Tenney (NY), who became a member of Congress in 2017, lost the following election, then returned in 2021
- Rep. Beth Van Duyne (TX), a former HUD official in the Trump administration

Possible 2023 priorities

Democratic priorities		Bipartisan priorities	Republican priorities	
Child Tax Credit expansion	BBB agenda: low-income tax credits, paid leave, housing, education, health	Debt limit, government funding beyond September 30, 2023, farm bill	Oversight of Biden administration	Health costs, consumer-driven health, access to AHPs, HSAs, transparency
Immigration reform	Health and racial equality	Section 174, Section 163(j) TCJA cliffs, tax extenders, other tax items	Rolling back Inflation Reduction Act IRS funding increase, Rx price negotiation	TCJA permanency, scrutiny of OECD-led global tax agreement
Data privacy rules (new protections for online privacy), tech antitrust	Climate legislation	Mental health, Medicare solvency, tele-health, workforce, PHE policies	Immigration: securing the southern border, keeping Title 42	Prohibit non-emergency drawdowns of the Strategic Petroleum Reserve

What to expect on tax in 2023

Republican-controlled House

Rolling back Inflation Reduction Act (IRA) IRS enforcement funding

- The Family and Small Business Taxpayer Protection Act (H.R. 23) passed the House 221-210 January 9 but isn't likely to be taken up in the Democratic-controlled Senate
- CBO estimated that the bill would increase deficits by >$100b over 10 years

TCJA permanency

- House Republicans may bring up bill(s) to extend expiring TCJA provisions
- Accelerating debate could draw distinctions between parties ahead of 2024 elections

Fair Tax Act

- Speaker McCarthy committed to vote to replace income tax with consumption tax

Global tax

- Implementation faced challenges in the last Congress and gets no easier with GOP control of House, Ways & Means; scrutiny over US involvement will intensify
- December 15, 2022, GOP letter to Sec. Yellen: Administration "made commitments in the OECD negotiations it has no authority to fulfill"

Democratic-controlled Senate

IRA oversight, housing

- Finance Chairman Wyden: will continue oversight of IRA implementation and focus on the high costs of housing and energy (he sponsors LIHTC enhancement bill)
- Wyden has noted his commitment to working with Treasury on IRA implementation

TCJA expiring provisions

Business tax cliffs

- **174 –** Five-year R&D expense amortization (15-year for foreign R&D) rather than expensing beginning January 1, 2022, *$7.5b/4-year delay*
- **163(j) –** Businesses' interest expense deductions limited by section 163(j) to 30% of earnings before interest, tax, depreciation, and amortization (EBITDA) before January 1, 2022, 30% of EBIT now *$20b/4-year delay*
- **Bonus depreciation –** phases out in 20% increments beginning in 2023 *$28b/4-year extension*

Individual provisions expiring in 2025

Based on JCT estimate of Protecting Family and Small Business Tax Cuts Act of 2018 (JCX-71-18)

- **Income tax rate brackets** 10%, 12%, 22%, 24%, 32%, 35%, 37% *$522b/through 2028*
- **Standard deduction** ($12,000/single, $24,000/married filing jointly) *$308b/through 2028*
- **Pass-through deduction** 20% – *$179b/through 2028*
- **Child tax credit :** $2,000 not indexed, refundable to $1,400 *$207b/through 2028*
- **AMT exemption** equal to $109,400 (joint), $70,300 (single), phase out at AGI >$1m (joint), $500,000 (single) *$283b/through 2028*
- **Estate tax** exemption doubled – *$28b/through 2028*
- **$10,000 SALT deduction cap**
  - Three-year extension estimated to raise $400b, based on model of 2022 Middle-Class Savings and Investment Act (Sen. Grassley et al)
    - Put another way, allowing cap to expire would forego $400b/3 years

Registered funds perspectives

Legislative developments impacting registered funds

- Inflation Reduction Act enacted August 2022
  - No or only minimal direct impact on most mutual funds and exchange-traded funds (ETFs)
  - Small number of funds registered under the Investment Company Act of 1940 (1940 Act) that are taxable as C corporations and not as "regulated investment companies" under the Internal Revenue Code of 1986 (Code) are impacted by:
    - New 1% Excise Tax on Corporate Stock Buybacks (effective for stock repurchases after December 31, 2022
    - New 15% Minimum Book Tax for Corporations (effective for TYBA December 31, 2022)
- SECURE Act 2.0 enacted December 2022
  - Code amended to permit 403(b) plans to invest in "81-100" group trusts, including collective investment trusts
  - Unfortunately, the bill as enacted does not include securities law amendments needed to allow 403(b) plans to invest in collective trusts; subsequent legislation needed
- Legislative initiatives in pipeline?
  - Possible resurrection of prior proposals?
    - Modernization of Derivatives Act
    - Repeal of gain nonrecognition exception for mutual funds and ETFs

What’s going on at the IRS in the registered fund space?

- European Court of Justice (ECJ) Reclaims
  - Very long road, but recently significant progress
  - After six years, IRS is finally processing and signing up closing agreements with funds that have received ECJ refunds in excess of foreign taxes paid that year
  - Expect funds to need closing agreements, potentially annually, for next several years as European Union countries increasingly pay refunds
- IRS has limited resources for other initiatives

ECJ reclaims heat map — investment funds

Sweden

Refunds granted to EU/EEA based funds (UCITS/AIFs), US RICs, Canadian funds.

France

Refunds granted to EU/EEA based funds (UCITS/AIFs), US RICs. Pending assessment of Canadian funds.

Spain

Domestic exemption available to EU/EEA based funds (UCITS). Refund granted to some AIFs and US RICs (favorable case law). Tax authorities are nevertheless rejecting most US RICs reclaims in first instance.

Portugal

Recent favorable ECJ case law (EU AIF) increases chance of success for both EU/EEA and third country funds. Expert reclaim process to include a court phase.

Italy

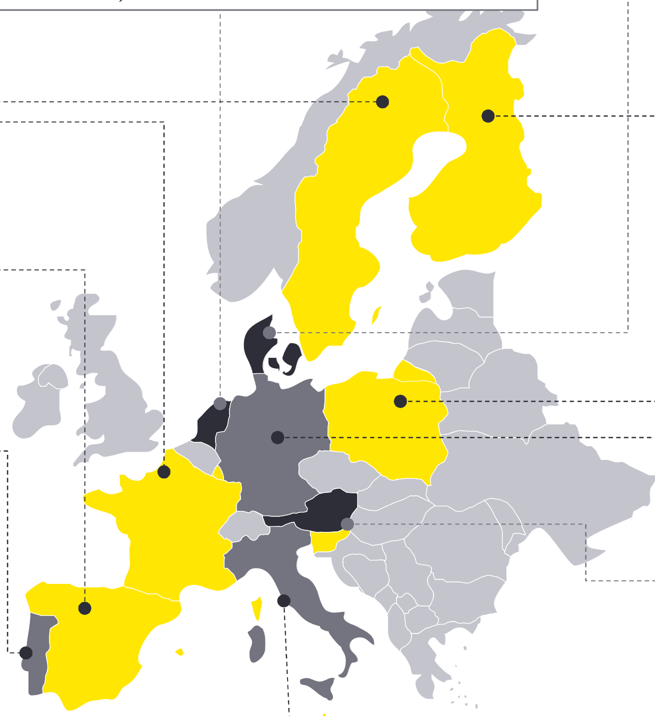
Domestic exemption available to EU/EEA funds (UCITS/AIFs) since 2021. Recent Italian Supreme court case law in favor of a US RIC.

Netherlands

Series of recent unfavorable case law negatively impacted the filing position of both EU/EEA and third country funds (e.g., US and Canadian funds)

Denmark

Series of recent unfavorable case law negatively impacted the filing position of both EU/EEA and third country funds (e.g., US and Canadian funds)



Finland

Refunds granted to EU/EEA based funds (UCITS/AIFs), US RICs, Canadian funds. Recent favorable case law addresses legal form requirements under both prior and new regime.

Poland

Refunds granted to EU/EEA based funds (UCITS/AIFs), US RICs, Canadian funds.

Germany

Various pending case law in front of the ECJ and the German Federal Fiscal Court and lower courts. Lower likelihood of success regarding 2018 and following. Possible seven-year statute of limitation. September 2022 meeting occurred between the tax authorities and tax advisors on EU reclaims.

Austria

Series of recent unfavorable case law negatively impacted the filing position of both EU/EEA and third-country funds (e.g., US and Canadian funds).

Legend

- Higher likelihood of success
- Moderate likelihood of success
- Lower likelihood of success

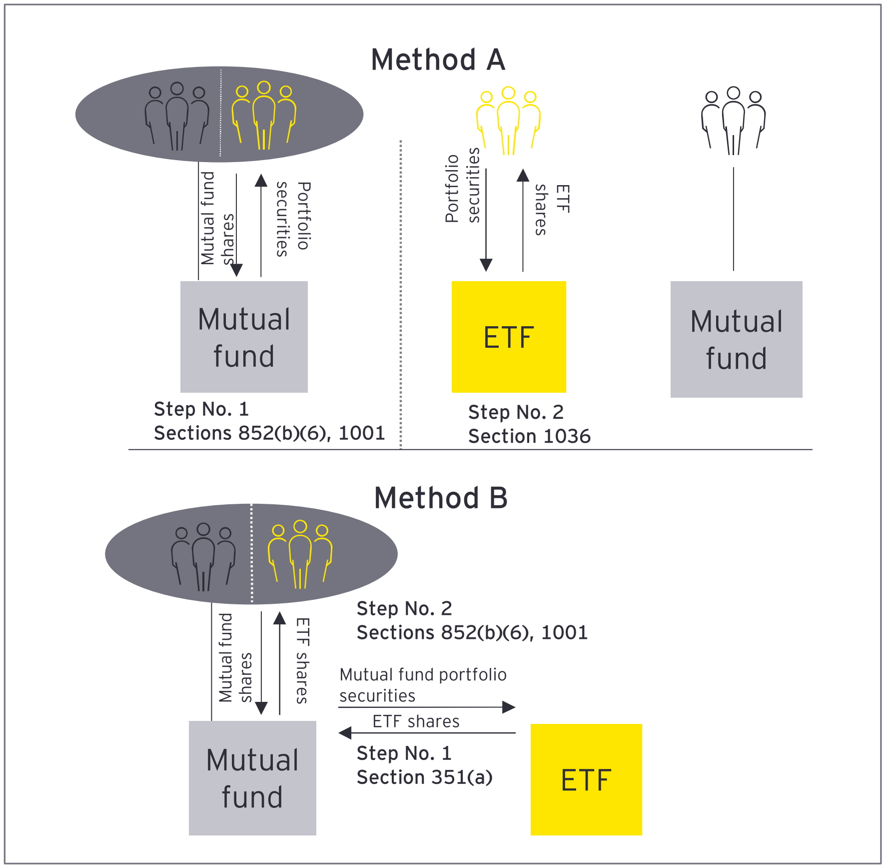
Note: The diagram above is intended for use as a high-level overview of EU reclaim opportunities for EU/EEA, US and Canadian investment funds. Further analysis of each fund characteristics required.

Mutual Fund-to-ETF conversions: primary options

- Option A: Direct conversion into an ETF
  - Same entity – amend SEC registration statement and organizational documents, modify operations and convert existing fund shares to ETF shares
  - Generally, no direct tax consequences to fund or shareholders, aside from cash in lieu of fractional shares
- Option B: Mutual fund merges into a newly organized "shell" ETF
  - Most (if not all) conversions to date have been via this Option B
  - Minimal tax consequences
    - Qualifies as a tax-free reorganization under the tax code
    - Tax entity continues without interruption (EIN, taxable year, tax attributes, etc.)
    - Generally, no direct federal income tax consequences to fund or shareholders, aside from cash in lieu of fractional shares
    - Some exceptions
      - e.g., funds with foreign securities more likely to incur foreign capital gain and transfer taxes with this Option B
- Operational challenges with both

Other options for creating and seeding an ETF

- Add an ETF share class to an existing mutual fund
  - Tax is straightforward, but regulatory hurdles exist, including need for SEC exemptive relief
- Split off part of mutual fund to new ETF (not ideal from tax perspective)
  - Move only some of the mutual fund's shareholders to the ETF
  - Can take two possible forms
    - **Method A:** In-kind redemption of mutual fund shares followed by in-kind acquisition of ETF shares
    - **Method B:** Mutual fund assets over to ETF in exchange for ETF shares, followed by in-kind redemption of mutual fund shares for ETF shares
  - If properly structured, fund should not recognize any embedded gains on securities that migrate to the ETF under either option
  - But both options result in taxable redemptions for the migrating shareholders

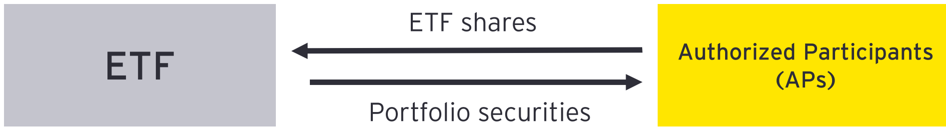


In-kind redemptions and gain nonrecognition rule

- Special Gain Nonrecognition Rule
  - A RIC doesn't recognize built-in gains on distribution of appreciated portfolio securities to a shareholder "if such distribution is in redemption of its stock upon the demand of the shareholder"
    - Exception to general gain recognition rule for other corporations
  - Adopted in 1969 for mutual fund industry, decades prior to creation of ETFs
    - Available to both mutual funds and ETFs but most used by ETFs because in-kind redemptions built into their ordinary operations
  - Rule's apparent policy
    - Relieves mutual funds from having to make forced sales of their securities to fund a shareholder redemption, including at potentially disadvantageous prices
    - Avoids generation of gains from those sales of securities that would need to be distributed to non-redeeming shareholders
  - Limited tax law guidance on rule's scope and application

Benefits of redemption-in-kind mechanism

ETF example



Basic steps for ETFs

- AP submits order to redeem creation units of ETF shares at next calculated NAV per share of ETF.
- ETF fulfills the order by distributing to the AP a basket of portfolio securities, generally equal to NAV of AP's redemption shares.
- Basket of ETF securities typically a pro rata slice or representative sample of ETF's holdings.
- ETF selects lowest-tax-cost lots of securities to include in basket (i.e., those with largest built-in gains).
- Built-in gains in those basket securities are not recognized by ETF for tax under gain nonrecognition rule.
- However, AP's redemption of ETF shares is taxable. AP recognizes gain/loss on ETF shares redeemed and receives baskets securities at FMV basis.

- Tax deferral, not avoidance
  - In general, ultimate effect of fund not recognizing built-in capital gains in a redemption is deferral of payment of taxes on those capital gains by non-redeeming taxable fund shareholders
    - Tax on those gains ultimately paid by taxable shareholders on their redemption or sale of fund shares
- Other benefits of in-kind redemption baskets
  - In-kind redemptions provide tax benefit to taxable shareholders, but provide other benefits to the fund and all its shareholders, including:
    - Reduced transaction costs
    - Reduced market impact
    - Less cash drag on fund returns
    - For ETFs, allowing for AP arbitrage of ETF price

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“Custom” in-kind redemptions: unique tax risks

- Also called heartbeat transactions or “friendlies”
- “Heartbeat transaction” first coined in 2017 by FactSet based on the EKG-like pattern seen on some index ETFs’ flows charts surrounding index rebalance dates
- Charts showing large AP inflows a few trading days **(typically two days)** ahead of a rebalancing with corresponding large AP outflows on or around rebalance date
- ETF’s redemption basket for the participating AP is a “custom” basket
  - Generally, includes only securities being removed from relevant index in the rebalance, instead of a pro rata basket
- Distinguishable from creates/redeems executed in ordinary course of ETF’s operations (i.e., based on external market activity with standard published baskets)
- SEC’s ETF rule opened door to general use of custom in-kind redemptions for active and passive ETFs
- Mutual funds sometimes use as well
- Generally higher tax risk than with ordinary course AP and other redemption transactions
  - Two-day holding period important

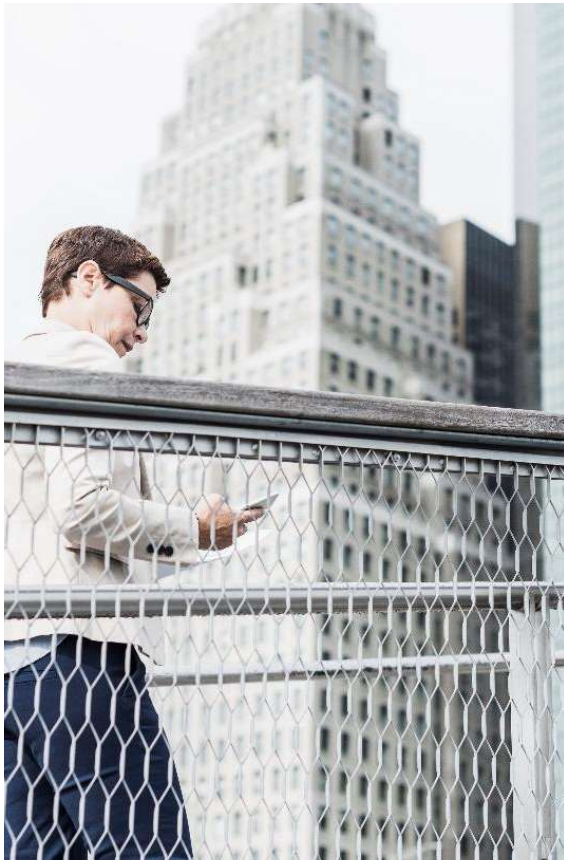
Source: “The Heartbeat of ETF Tax Efficiency” https://insight.factset.com/the-heartbeat-of-etf-tax-efficiency?_ga=2.9210421.108055649.1554730162-2101567409.1525188635

Establishing an in-kind redemption program

- Mechanics and operation of an in-kind redemption program should be designed with tax risks and compliance in mind
- Ways to manage and mitigate tax include, for example:
  - Incorporate in an ETF's SEC-mandated policies and procedures for construction and acceptance of baskets under ETF Rule, specific parameters for redemption basket construction and in-kind transactions with tax in mind
  - Create desk-level procedures for portfolio management and other relevant teams on tax restrictions
  - Obtain a tax opinion covering a fund's custom in-kind redemption practices, policies and procedures
- Some threshold considerations:
  - Is there a need for a formalized redemption in-kind program with compliance policies and procedures?
  - What is the overall importance of tax management in the fund or ETF? For instance, is it important for attaining scale and competing with competitors' products?
  - What is the fund sponsor's and board's acceptable level of tax risk?

Industry drive for greater tax efficiency

- Structural and other considerations
  - Type of wrapper
    - Mutual Funds vs. ETFs
    - Collective investment trusts or separately managed accounts as alternatives
  - Distribution of shares
    - Taxable vs. tax-exempt shareholders
  - Investment strategy
    - Active vs. passive investment strategy
    - Type of investment assets (e.g., stocks, bonds, domestic, foreign)
- Methods
  - In-kind redemption program
  - Tax loss harvesting program
    - Avoiding the "wash-sale" rule
  - Synthetic/derivative investments that are more tax efficient than physical
  - Portfolio manager tax education



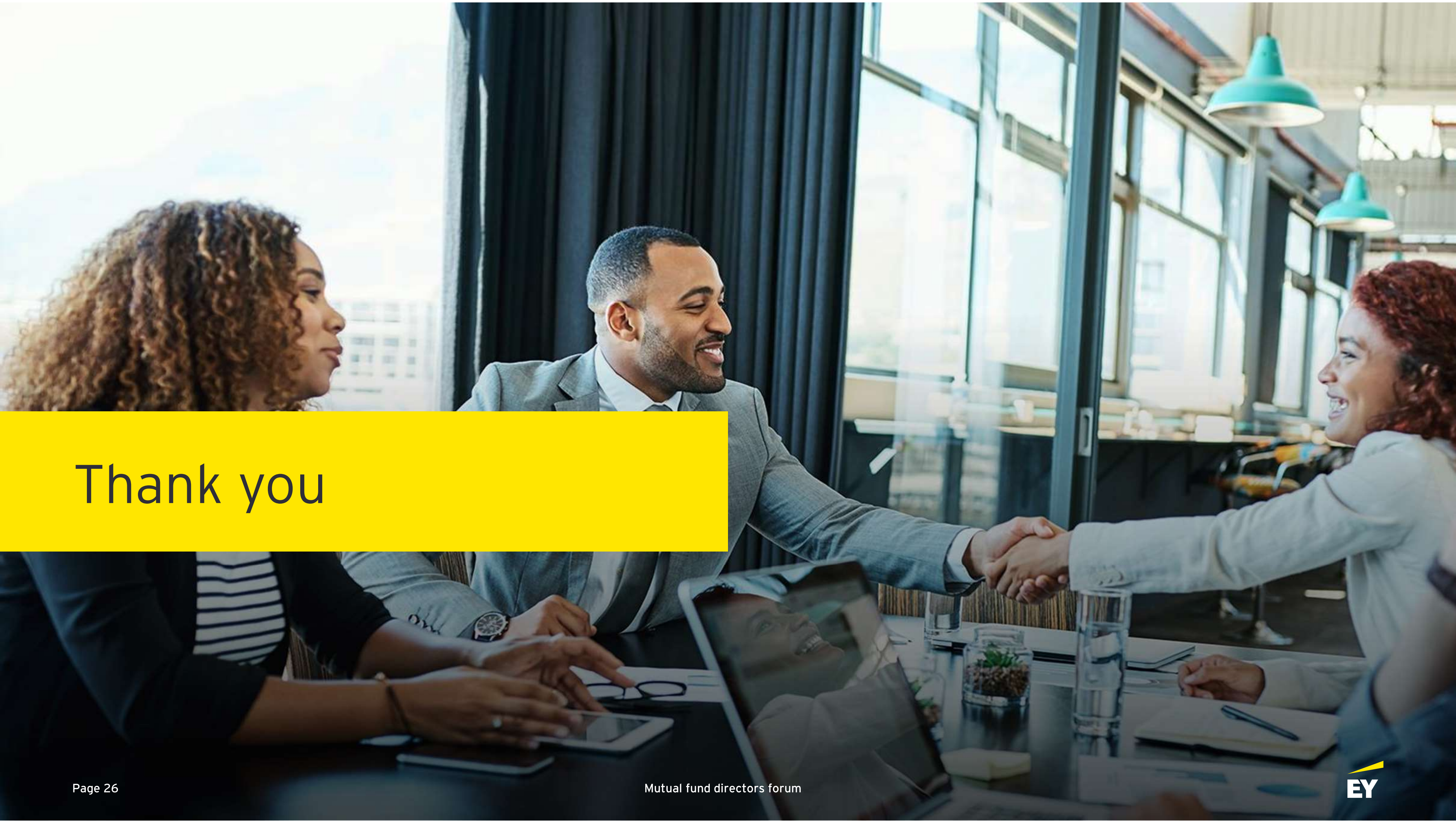
Alternative funds in a 1940 act wrapper: tax considerations

- Types of recent popular strategies
  - Private Equity
  - Private Credit
  - Real Estate and Infrastructure
  - Digital Assets
- Different 1940 Act wrappers
  - Business development companies (BDCs)
  - Interval funds
  - Closed-end funds with periodic repurchase offers
- Special Tax Considerations and Compliance Risks
  - RIC asset diversification and qualifying income tests
  - RIC distribution requirements

Other hot topics

- Tax Technology, Innovation and Automation
- The Future of Fund Tax
  - Industry initiative to revise the tax code
  - Drive toward customization
    - Direct indexing
    - Personal tax management

Questions?



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