IRS issues proposed regulations and revenue procedure 2014-45 on method of accounting for gains and losses and loss disallowances on shares in money market funds with a floating net asset value

Recently, the Internal Revenue Service (IRS) released a set of proposed regulations (the "Proposed Regs"), under Internal Revenue Code (IRC) sections 446 and 6045[1], and Revenue Procedure 2014-45 (the "Rev. Proc.") addressing potential tax issues presented by securities law changes imposed by the Securities and Exchange Commission (SEC) governing money market funds with a floating net asset value (Floating-NAV MMF). The guidance addresses the calculation of gain or loss on the sale of Floating-NAV MMF shares, information reporting with respect to the sale of such shares, and the impact of the wash sales rules under section 1091 in connection with relevant sales transactions of Floating-NAV MMF shares.

Background

Historically, money market funds have been purchased and sold by taxpayers at a consistent price (typically $1); therefore, these transactions have not generated capital gain or loss for federal income tax purposes. Likewise, money market funds have been exempted from information reporting requirements under sections 6045, 6045A, and 6045B.

The SEC recently voted to require certain institutional money market funds to price their shares in a manner that more accurately reflects the market value of the funds' underlying portfolios. These particular MMFs will no longer be able to utilize the special exemptions that currently allow them to maintain a stable net asset value (NAV), and instead the share price will float, so the funds will be known as Floating-NAV MMFs. As a result, where a shareholder has a high volume of purchase and sale transactions in a Floating-NAV MMF (such as where the fund is used as a "sweep arrangement"), the shareholder may experience a high volume of gains and losses, which likely will be relatively small in amount. Given the potential high volume of such transactions, the determination of cost basis associated with the sales transactions and the reporting of gains and losses would be extremely burdensome to investors and funds. Likewise, losses on the sale of Floating-NAV MMF shares would likely give rise to a substantial number of wash sale transactions for fairly small amounts, given the high volume of sales and purchases in such accounts. In response, the Treasury Department and the IRS have issued proposed regulations providing a simplified, aggregate annual method of tax accounting for these gains and losses, simplifying the tax treatment and promoting compliance. Additionally, the IRS published Rev. Proc. 2014-45 exempting Floating-NAV MMF shares from the wash rules under section 1091.

Proposed Treasury Reg. § 1.446-7: Simplified method of accounting for Floating-NAV MMF shares (NAV method)

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[1] Unless otherwise specifically stated, all section references are to the Internal Revenue Code of 1986, as amended.

Proposed Treasury Reg. Section 1.446-7 introduces the net asset value method, or NAV method - a simplified method of accounting for gain and loss on Floating-NAV MMF shares. Under this method, gain or loss is based on the change in the aggregate value of the shares in the Floating-NAV MMF during a computation period, which may be the taxpayer's taxable year or certain shorter periods, and the net amount of the purchases and redemptions during the period. More specifically, the taxpayer's net gain or loss from shares in a Floating-NAV MMF for a computation period generally equals the value of the taxpayer's shares in the MMF at the end of the period, minus the value of the taxpayer's shares in the MMF at the end of the prior period, minus the taxpayer's "net investment" in the MMF during the period. For this purpose, net investment is equal to the aggregate cost of the shares purchased by the investor during the computation period minus the aggregate amount received upon taxable redemptions during such period. The NAV method does not change the tax treatment of, or broker reporting requirements for, dividends from floating-NAV MMFs. Additional operating considerations of the NAV method are:

- The character of a shareholder's net gain or loss depends on the character of the underlying shares in the shareholder's hands.[2]
- To the extent a shareholder's NAV method net gain or loss is capital in nature, it will be treated as short-term capital gain.[3]
- If Floating-NAV MMF shares are held through more than one brokerage account, the taxpayer must treat holdings in each account as a separate Floating-NAV MMF for applying the NAV method, and also apply the NAV method calculation separately to each account.[4] Taxpayers may adopt the NAV method pursuant to rules under Treas. Reg. section 1.446-1(e) by use of the NAV method in the Federal income tax return for the first taxable year in which the taxpayer holds shares in a floating-NAV MMF.[5] Once a taxpayer has adopted a method of accounting for gains and losses on shares in Floating-NAV MMFs, any change from that method (including a change to or from the NAV method) is a change in method of accounting to which the provisions of section 446 and the accompanying regulations apply. The proposed regulations provide that the change is implemented on a cut-off basis.
- The proposed regulations apply to taxable years ending on or after the date they are adopted as final. Taxpayers may rely on them for taxable years ending on or after July 28, 2014 and beginning before the date they are adopted as final.

Investors in money market funds subject to the new floating NAV rule (including regulated investment companies and hedge funds) electing to use the NAV method will need to determine how to operationalize the calculations and determine whether accounting system changes are necessary.

Proposed Treasury Reg. § 1.6045-1(c)(3)(vi): Information reporting for Floating-NAV MMF shares

Under current law, money market funds subject to SEC Rule 2a-7 are excepted from certain broker-reporting requirements, including cost-basis and gross proceeds reporting, provided that the money market fund computes its current price per share for purposes of distributions, redemptions, and purchases so as to stabilize the price per share at a constant amount that approximates its issue price or the price at which it was originally sold to the public.[6] The proposed regulations would modify current law to except all money market funds subject to SEC Rule 2a-7 from these broker-reporting requirements, including Floating-NAV MMF, as it is the IRS view that imposing broker reporting requirements, including cost basis reporting, transfer reporting, and corporate action reporting, on floating-NAV MMFs would result in administrative burdens that are not justified in light of the expected relative stability of floating-NAV MMF share prices.[7] The proposed rule applies to sales of shares in calendar years beginning on or after the date the rules become final. Taxpayers and brokers, however, may rely on the proposed rules for sales of shares in calendar years beginning before these proposed regulations become final.

Rev. Proc. 2014-45 – Wash sales rules

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[2] Prop Treas. Reg. § 1.446-7(c)(3)(i).
[3] Prop Treas. Reg. § 1.446-7(c)(4).
[4] Prop Treas. Reg. § 1.446-7(c)(5).
[5] Rev. Rul. 90-38 (1990-1 CB 57). 26 CFR Part 1[REG-107012-14]
[6] Treas. Reg. § 1.6045-1(c)(3)(vi)
[7] 26 CFR Part 1[REG-107012-14]

Historically, due to the presence of a stable NAV, the loss disallowance rules under IRC Section 1091, commonly referred to as the "wash sales rules", have not applied to money market transactions. Under the new SEC regulations, Floating-NAV MMF share sales may result in loss transactions and could potentially create losses subject to the wash sale rules (albeit in relatively small amounts). Rev. Proc. 2014-45 provides that redemptions of shares of money market funds, which are expected to have relatively stable values even when share prices float, do not give rise to the concern that section 1091 is meant to address. Moreover, given the expected volume of transactions in Floating-NAV MMF shares, tracking wash sales of money market fund shares will present shareholders of Floating-NAV MMFs with significant practical challenges. As such, the Rev. Proc. will effectively except losses realized on money market fund redemptions to the extent the money market fund is regulated as such under the Investment Company Act of 1940, holds itself out as a money market fund, and is a Floating-NAV MMF. Rev. Proc. 2014-45 is effective for redemptions on or after the effective date of the SEC MMF Reform Rules, which is expected to be 60 days after the date that they are published in the Federal Register.

Investors (including regulated investment companies and hedge funds) who employ automated wash sales solutions and who will comply with Rev. Proc. 2014-45 may need to assess whether system changes are necessary to correctly exclude Floating-NAV MMF shares from wash sales calculations.

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