Current Regulatory and Legislative Developments Impacting Investment Funds

Tax Cuts and Jobs Act (TCJA) 2017

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TCJA: Section 199A

- New section 199A provides 20% deduction for “qualified business income” plus certain dividends from REITs, cooperatives, and publicly traded partnerships.
- Effectively reduces top individual income tax rate on REIT dividends from 37% to 29.6%.
- Section 199A does not expressly provide for pass-through of qualified REIT dividends and PTP income by a RIC to its shareholders.
Section 199A: Mutual Funds

Pass-through treatment

- Can RICs that invest in REITs and MLPs pass through this income to shareholders? Large percentage of REIT investors own REITs through funds.
- Post-TCJA, REITs pay the following types of dividends (with applicable tax rate):
  - Qualified dividend income (15%/20%) (passes through a RIC)
  - Capital gain dividend (15%/20%) (passes through a RIC)
  - Ordinary income dividend (20% deduction as qualified REIT dividend; unclear if it passes through a RIC)

Shareholder disclosure

Operational and reporting concerns

- 2018 IRS form 1099-DIV includes a box for 199A dividends
- Will there be sufficient time to implement pass-through treatment for 2018 tax reporting system?
Section 199A: Status of RIC Guidance

- JCT Blue Book indicates intent to pass-through REIT dividends and PTP income to RIC shareholders.
- Office of Management and Budget (OMB) received proposed regulations, “Guidance under section 199A (RIC-REIT) [TCJA]” on Dec 13, 2018:
  - 45-day review period ends January 27 (barring any extensions).
- Technical Corrections Bill and Explanations:
  - PTP losses must be reported to shareholders.
TCJA: Interest Expense Deduction Limitation

- Section 163(j): amended to provide new limitations on net business interest expense – limited to 30% of adjusted taxable income (ATI)

- Notice 2018-28: RICs have business interest expense and income

- Proposed regulations (REG-106089-18) (Nov 26, 2018)
  - ATI includes all of RIC’s income and gains; determined before application of sec. 561 dividends paid deduction
  - E&P not reduced by business interest expense disallowed under 163(j) in the year disallowed, or by any excess business interest expense allocated from a partnership
TCJA: Section 451(b)

- Section 451(b) generally requires an accrual basis taxpayer to treat the “all events test” as satisfied with respect to an item of income no later than when the taxpayer includes it as revenue on an “applicable financial statement”

- Based on legislative history appears provision was intended to address tax treatment of certain credit card fees (Capital One) but after enactment there was concern that scope was wider and would pull in market discount & OID

- Notice 2018-80: stated 451(b) does not apply to market discount

- Applicability to original issue discount (OID) still unclear – would be significant operational headache for RICs with no clear benefit to fisc
Section 451(b): Original Issue Discount

- ICI Comment: 451(b) should not apply to OID outside the context of fees or other items that are treated as something other than discount for book purposes
  - Intended to overturn *Capital One* case and prior IRS rulings, which allowed taxpayers to treat certain credit card and other fees as OID
  - Outside the context of these fees, OID is treated as discount for both book and tax purposes
    - Both use yield-to-maturity principles to determine accruals, but minor differences exist
    - Notably, GAAP does not allow for *de minimis* OID
    - Compliance burden for RICs would be significant – would require maintaining multiple sets of books and records and manual comparisons to determine which accrues faster
TCJA: Section 965

- Toll charge: Require US shareholders owning 10% or more of a foreign corp to include as current income their pro rata share of foreign corp’s post-1986 undistributed accumulated earnings and profits for the last taxable year beginning before Jan 1, 2018; taxpayers may elect to pay net tax liability over 8-year period

- RICs typically do not own more than 10% of a non-wholly owned CFC; when they do, they hold shares as a portfolio investor; foreign corporations may not have information available or be willing to provide information needed to determine:
  - Whether the foreign corporation is a specified foreign corporation, and
  - Its post-1986 undistributed accumulated earnings and profits under US tax principles.

- Special statutory rule for REITs: can elect to take deemed income inclusion into income over 8-year period (distribute to shareholders)
  - Deemed income inclusion not taken into account for REIT gross income test
Section 965: RIC Guidance and Open Issues

- Proposed Regulations (REG-104226-18) (Aug 3, 2018): decline to permit RICs to use the 8-year period, since not statutorily permitted
  - In the preamble to the proposed regulations, Treasury acknowledges that obtaining accurate information may be a struggle for minority shareholders; but notes that the issue is not limited to sec. 965

- Revenue Procedure 2018-47 (Sep 2018) permits the 2017 sec. 965 inclusion to be treated as arising on Jan 1, 2018

- Interaction with 2016 Proposed Regulations that require an actual distribution for Subpart F and QEF inclusions to qualify as “good income.”

- Similar issue arises with global intangible low-taxed income (GILTI) regime (treated as subpart F income for purposes of sec. 851(b)).
TCJA: Section 988

- Nonfunctional Currency
  - Request for guidance on revisions to existing regulations
    - Federal Register Vol. 83, No. 236, pg. 63558 (Dec 10, 2018)
Single Security Initiative

- Key features and terms of Freddie Mac’s securities will be aligned with those of Fannie Mae’s securities to create new Uniform Mortgage Backed Securities (UMBS); traded primarily in the “To-Be-Announced” (TBA) market

- Rev. Rul. 2018-24: exchange not a section 1001 event

- Rev. Proc. 2018-54: can elect to treat UMBSs as having certain deemed issuers (Deemed Issue Ratio) to satisfy diversification requirements of section 817(h)
  - Does the guidance apply to UMBS TBA contracts?
  - Does the Deemed Issue Ratio apply separately to a TBA contract and the UMBS that is received if the TBA is physically settled?
Select International Issues

- **FATCA Proposed Regulations (REG-132881-17) (Dec 18, 2018)**
  - No withholding tax on gross proceeds or capital gain distributions

- **Germany & France**: laws enacted to shut down dividend arbitrage
  - Laws effective as of Jan 1, 2018 (Germany) and July 1, 2019 (France)
  - Beginning of a larger EU trend?

- **India-Mauritius**: tax-free mergers involving trusts, consultation

- **Korea**: overseas investment vehicle (OIV) regime

- **Switzerland**: establishing treaty eligibility
Other Investment Funds

- **UBTI – TCJA enacted new 512(a)(6)**
  - Requires exempts to calculate UBTI separately for each trade or business.
  - Prior to TCJA could aggregate gross income and allowable deductions across all trades and businesses.

- **ECI from disposition of partnership interests**
  - Proposed regulations (REG-113604-18) (Dec 26, 2018)
Other Investment Funds

- **Guaranteed payments**
  - Proposed regulations (REG-106089-18) (November 27, 2018)

- **Centralized Partnership Audit Regime**
  - Final Regulations (T.D. 9844) (Dec 24, 2018): §301.6225-2(d)(5)
    - Could deny MLPs from using passive suspended losses allocated to mutual funds to offset imputed underpayments
    - Sec. 6225(c)(5) specified partner: “described in sec. 469(a)(2)”.
      469(k)(4) treats RICs as “described in (a)(2)”
    - Regulation text leaves out this reference
Other Investment Funds

- Notice 2019-06 (Dec 21, 2018)
- Proposed regulations (REG-115420-18) (Oct 19, 2018)

- UMBS – impact on 817(h) diversification testing