IRS provides excise tax relief for RICs with transition tax inclusions

Summary of relief

On September 6, 2018, the Internal Revenue Service (IRS) issued Rev. Proc. 2018-47, which provides excise tax relief for regulated investment companies (RICs) that have inclusions under section 951(a)(1) as a result of the new transition tax under section 965 ("transition tax inclusion") for the excise tax year that ended December 31, 2017. The IRS stated that it will not challenge a RIC's treatment of a 2017 subpart F inclusion stemming from the transition tax on deferred foreign income under section 965 as long as the RIC meets the following requirements:

1. The RIC must treat any 2017 transition tax inclusion in the same manner as a specified gain under section 4982(e)(5)(B)(i) that would (but for section 4982(e)(5)) be taken into account during the portion of the RIC's 2017 excise tax year that is after October 31, and
2. The RIC must treat any deduction under section 965(c) attributable to the 2017 transition tax inclusion in the same manner as a specified loss under section 4982(e)(5)(B)(ii)) that would (but for section 4982(e)(5)) be taken into account during the portion of the RIC's 2017 excise tax year that is after October 31.

Background

Section 4982(a) imposes an excise tax on undistributed income of most RICs for each calendar year. Many items of ordinary income, such as dividends and interest, are periodic and relatively predictable in amount. When section 4982 was added to the Internal Revenue Code by the Tax Reform Act of 1986 (P.L. 99-514), it provided that a RIC's required distribution for a calendar year was based in part on the RIC's ordinary income for the entire calendar year. Section 4982 has been amended several times to provide an October 31 year-end for measuring various nonperiodic items of ordinary income. Section 4982(e)(5), for example, defers ordinary income from specified gains and losses that occur after October 31 of a calendar year until January 1 of the following calendar year for section 4982 purposes.

Section 965(a), as amended by the 2017 Tax Act[1] (the Act), provides that for the last tax year of a deferred foreign income corporation (DFIC) that begins before January 1, 2018, the corporation's subpart F income will be increased by the greater of its accumulated post-1986 deferred foreign income as of November 2, 2017, or December 31, 2017. Section 965(b) may cause the amount of the inclusion under section 965(a) to be reduced. Section 965(c) provides a deduction to a DFIC's U.S. shareholder in the year that the shareholder has an inclusion under section 951(a)(1) as a result of section 965.

If the taxable year of a DFIC is the calendar year, the subpart F income of the DFIC will be increased by the amount described in section 965(a) for the taxable year of the DFIC ended December 31, 2017. Under sections 951(a)(1)(A) and 965(e)(2), a RIC that is a United States shareholder (as defined in section 951(b)) of such DFIC must include in gross income its pro rata share of the DFIC's subpart F income for its taxable year that includes or ends on December 31, 2017. Section 4982(e)(1)(C) provides that for excise tax purposes, the ordinary income portion of the required distribution is determined by treating the calendar year as a RIC's taxable year. As a result, amounts included in a RIC's income

[1] An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (the Act).

under section 951(a)(1), by reason of section 965, from a calendar-year DFIC, increase the RIC's 2017 required distribution under section 4982.

The Act was enacted on December 22, 2017, and contained provisions that required certain RICs both to compute the transition tax inclusion and to make corresponding distributions by December 31, 2017. Taxpayers requested relief citing the administrative burden of obtaining information from a DFIC, computing the required amounts, and making the required distributions in such a short period of time.

A transition tax inclusion is not a specified gain under section 4982(e)(5) because it is not an ordinary gain from the sale, exchange, or other disposition of property. However, the inclusion is a nonperiodic item of ordinary income required to be computed as of November 2, 2017, and December 31, 2017. Thus, the period during which a RIC could pay dividends for a transition tax inclusion under section 951(a)(1) as a result of section 965 for a calendar-year DFIC ended very shortly after the amendment of section 965 and on the same date that the amount of any inclusion could be computed. Therefore, the Department of the Treasury and the IRS determined that it was in the interest of sound tax administration to allow additional time for a RIC to make the required distribution under section 4982.

Observations

Except in the case of commodity-based funds, most RICs generally do not hold 10-percent or more of the voting power or value of the stock of a foreign corporation and should not be impacted by the transition tax inclusion. In certain circumstances, however, a RIC may be impacted by the transition tax inclusion where section 965 amounts flow through to the RIC from an investment in an underlying partnership or the RIC's portfolio consists of stocks in a relatively small international index. Therefore, it is important to examine a RIC's portfolio carefully to understand whether or not the RIC is impacted by the transition tax inclusion. This may be particularly important for business development companies and/or registered fund-of funds.

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