CLIENT ALERT

IRS Provides Excise Tax Relief for RICs Subject to 'Transition Tax' in 2017

September 7, 2018

AUTHOR

Roger Wise

Revenue Procedure 2018-47, released on September 6, provides welcome excise tax relief for the small number of regulated investment companies ("RICs") that were adversely affected by the "transition tax" enacted as part of the Tax Cuts and Jobs Act ("TCJA"). These RICs held 10% or more of the stock of a foreign portfolio company at the end of 2017.

The TCJA enacted a participation exemption, which generally allows a U.S. corporation to avoid tax on dividends received from a foreign subsidiary. (Under prior law, earnings of a foreign subsidiary were subject to U.S. tax when repatriated.) The price for transitioning to this system was that any U.S. person that owned 10% or more of the stock of a calendar-year foreign corporation on December 31, 2017, was required to include in income during 2017 the U.S. person's share of all the earnings of the foreign corporation that had been deferred offshore under prior law. This "section 965 inclusion" is a "phantom" item: the U.S. shareholder must increase its income by this amount even though there is no matching cash distribution from the foreign corporation. In general, the section 965 inclusion is an issue for a RIC with a large investment in a foreign portfolio company. A RIC that invests in commodities through a wholly owned offshore subsidiary does not face this issue. Such a RIC must include the commodity subsidiary's earnings in income each year under the "subpart F" rules for offshore corporations earning passive income, leaving no deferral benefit for the transition tax to recapture.

A RIC that held 10% or more of the shares of a calendar-year foreign corporation on December 31, 2017, faced excise tax problems because of these rules. RICs are subject to a 4% excise tax to the extent they do not distribute, during the calendar year, at least 98% of their ordinary income and 98.2% of their capital gains. The TCJA was enacted on December 22, 2017, making it virtually impossible for RICs to make the required distributions by year-end. The excise tax provisions allow RICs to treat certain late-year items, generally of a non-recurring nature, as arising on January 1 of the following year. Revenue Procedure 2018-47 allows RICs to "push" a section 965 inclusion to 2018 in the same manner. In effect, this gives RICs an extra calendar year to meet the excise tax distribution requirements with respect to any section 965 inclusion, just as with other "specified gains and losses."

To avoid an entity-level income tax, RICs also must distribute all of their income for each taxable year. Revenue Procedure 2018-47 only provides relief from the excise tax, because RICs can generally rely on "spillback" dividends to meet the regular distribution requirement. With a spillback dividend, a RIC would treat a distribution during 2018 as satisfying its distribution requirement with respect to 2017.

Although Revenue Procedure 2018-47 will allow the small number of RICs with a section 965 inclusion to avoid the excise tax, these RICs will still generally need to find cash from other sources to satisfy the distribution requirements with respect to this income. The sale of other assets to raise this cash could generate capital gains, which of course would also need to be distributed.

If you have any questions regarding this client alert, please contact the following attorney or the attorney with whom you regularly work.

Roger Wise
202 303 1154
rwise@willkie.com