CLIENT ALERT

Proposed Regulations Allow Mutual Funds and ETFs to Pass Through 20% Deduction for REIT Dividends

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Regulations released on January 18, 2019, permit mutual funds and exchange-traded funds taxed as regulated investment companies (“RICs”) to pass through to their shareholders the special treatment of dividends received from real estate investment trusts (“REITs”). RICs may rely on these regulations, even though only in proposed form, for 2018 Forms 1099 that will soon be sent to shareholders.

The Tax Cuts and Jobs Act, enacted December 22, 2017, created a 20 percent “qualified business income” deduction for individuals and other non-corporate taxpayers, effective from 2018 through 2025. The deduction applies to ordinary or “qualified” REIT dividends, income and loss from certain publicly traded partnerships (“PTPs”), and income and loss from certain (generally, non-professional) trades and businesses. Qualified REIT dividends include ordinary dividends paid by any REIT, whether it invests in mortgages or real property. The deduction produces an effective federal tax rate of 29.6 percent for income otherwise subject to tax at the top individual rate of 37 percent.

Section 199A as enacted allowed a direct REIT shareholder to claim this benefit, but did not provide a mechanism for a RIC investing in REITs to pass this benefit through to its shareholders. This created an anomalous situation for RICs, which are generally permitted by statute to pass through preferential tax rates or the preferential treatment afforded to the following types of income: net capital gains, exempt interest, income eligible for the dividends received deduction (“DRD”), qualified dividend income (“QDI”), and (for non-U.S. shareholders) interest-related and short-term capital gain dividends. Extending conduit treatment to qualified REIT dividends appeared to be the correct policy result.

However, there was some uncertainty as to whether the statute provided sufficient regulatory authority to allow conduit treatment in this context. In late December 2018, the Joint Committee on Taxation offered the following explanation of congressional intent in the "Blue Book" on the Tax Cuts and Jobs Act: "It is intended that in the case of an individual shareholder of a RIC that itself owns stock in a REIT or interests in a publicly traded partnership, the individual is treated as receiving qualified REIT dividends or qualified publicly traded partnership income to the extent any dividends received by the individual from the RIC are attributable to qualified REIT dividends or qualified publicly traded partnership income received by the RIC." A November technical corrections bill also included a provision broadly similar to the proposed regulations, further supporting this view of congressional intent. Finally, the preamble to the proposed regulations noted the precedent of using regulations, rather than specific statutory language, to permit RICs to pass through different rates of capital gains (for example, 28 percent for collectibles gain).

The proposed regulations adopt the mechanisms that apply to other special categories of RIC dividends. A shareholder can treat RIC dividends as qualified REIT dividends to the extent of the RIC's income that is reported to shareholders as "section 199A dividends." This amount equals the RIC's qualified REIT dividends reduced by RIC deductions that are properly allocable to such income. If the amount reported by the RIC exceeds its actual income from qualified REIT dividends, the RIC's section 199A dividends are reduced accordingly. For non-calendar year RICs, the reduction applies first to post-December dividends, following statutory rules enacted in 2010 that seek to minimize the need for corrected Forms 1099.

Proposed section 199A regulations issued in August 2018 impose a holding period requirement, modeled on the rules for the pass-through of DRD income and QDI, on direct REIT shareholders "to prevent dividend stripping and similar transactions aimed at capturing qualified REIT dividends without having economic exposure to the REIT stock for a meaningful period of time." The new proposed regulations impose similar requirements on RIC shareholders. Pass-through treatment does not apply to a dividend received by a RIC shareholder who has not held the RIC shares for at least 45 days during the 91-day period straddling the ex-dividend date or is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

The Blue Book also notes congressional intent to permit conduit treatment under section 199A for a RIC's PTP income and loss. Treasury and the IRS, however, continue to consider whether this is appropriate given the novel issues presented— in particular, the treatment of PTP losses.

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

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