

CLIENT ALERT

New IRS Regulations Permit Mutual Funds to Treat Income from Offshore Subsidiary as Qualifying Income Even When Subsidiary Does Not Distribute Income

March 20, 2019

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On March 18, the IRS released final regulations that will permit a regulated investment company (“RIC”) to treat income inclusions with respect to an offshore subsidiary as qualifying income even without a matching distribution of those earnings to the RIC.

RICs and Commodity-Related Income

The saga of these rules began with a 2006 revenue ruling which held that a RIC’s income from commodity-related derivatives is not qualifying income under the requirement that at least 90% of a RIC’s income each year must be derived from certain enumerated categories. Through private letter rulings (“PLRs”), the IRS then permitted RICs to gain commodity exposure through a wholly owned offshore subsidiary. Such an offshore subsidiary is treated as a controlled foreign corporation (“CFC”) and the RIC, as the United States shareholder, must include in income each year its share of the CFC’s commodity-related income and other passive income (referred to as “subpart F income”), whether or not distributed. When the earnings are actually distributed, the Internal Revenue Code makes clear that the RIC’s income from the subsidiary is treated as a dividend (and thus as qualifying income). The PLRs treated these income inclusions as qualifying income—under the category for “other income” with respect to the RIC’s business of investing in stocks,

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securities or currencies—even in the absence of a distribution. Similar reasoning applied to a RIC's income inclusions with respect to a passive foreign investment company with a qualified electing fund ("QEF") election in effect.

After the IRS stopped issuing new PLRs in 2011 in response to criticism from Congress, mutual funds continued to rely on the existing PLRs, or on opinions of counsel based on the reasoning of the PLRs, to treat income from a CFC as qualifying income even in the absence of a distribution. Proposed regulations released in 2016, however, would have treated a RIC's income from a CFC or QEF as qualifying income only when matched with a distribution.

The new final regulations reverse the approach of the 2016 proposed regulations. Under the final regulations, so long as the CFC or QEF income is derived with respect to the RIC's business of investing in stock, securities, or currencies, the RIC can treat it as qualifying "other income" when there is no matching distribution. This treatment should also apply to a RIC's inclusion of global intangible low-taxed income ("GILTI"), which is CFC operating income that, in certain circumstances, must be included in income by its United States shareholders.

The IRS reversal is likely explained by new provisions enacted as part of the Tax Cuts and Jobs Act, such as the GILTI rules, that require income inclusions by a RIC in situations where it has no control over whether a distribution is made. These new rules were enacted without special consideration of the possible impact on RIC qualification, implying that Congress did not believe there would be such an impact. Criticism of the inconsistencies that would be created by the proposed regulations—for example, treating interest and dividends as qualifying income if earned by a RIC directly but not if earned through a CFC or QEF and not distributed—also played a role.

The final regulations do not address whether the PLRs will be revoked. The new regulations, however, provide more general guidance not tied to the specific factual representations in the PLRs.

The final regulations should provide more operational flexibility for RICs with investments in offshore corporations. Although a RIC now does not need to receive a distribution from a CFC in order to treat its income from the CFC as qualifying income, the RIC will still need to distribute to its shareholders substantially all of its income—including the income from the CFC—to avoid entity-level tax.

The new regulations are generally effective 90 days after publication, but taxpayers may rely on the rule for CFC income for taxable years that begin after September 28, 2016 (the date on which the proposed regulations were issued).

Guidance on Securities

The preamble to the final regulations also reiterates the IRS position from 2016 that ordinarily it will not issue rulings on RIC qualification issues that require a determination of whether a financial instrument or position is a security under the Investment Company Act of 1940. That position led to the revocation of PLRs issued after 2006 that treated income from certain commodity-linked notes as qualifying RIC income.

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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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