

Chapman Client Alert

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Current Issues Relevant to Our Clients

Unexpected IRS Guidance on RICs with CFC Income

Last week, the IRS contemporaneously released two pieces of guidance related to the question of whether qualifying regulated investment company (“RIC”) income could include indirect commodities income through controlled foreign corporations (“CFCs”) or derivative exposure to commodities. The new guidance consists of proposed regulations under Section 851 and Revenue Procedure 2016-50.

The proposed regulations specify that, contrary to previously issued private letter rulings, Subpart F inclusions without matching distributions are not qualifying RIC income.

Revenue Procedure 2016-50 provides that the IRS ordinarily will not issue rulings or determination letters on any issue relating to the treatment of a corporation as a RIC that requires a determination of whether a financial instrument or position is a “security” under the Investment Company Act of 1940 (the “1940 Act”).

Practical Impact

Fortunately, the practical impact on most funds should be minimal. Most funds that have obtained commodities exposure through a CFC already require that the CFC make distributions in the year the CFC has commodities income, so the proposed regulations will just be a confirmation of their current practices. Funds that have allowed the distribution to occur in the year following the year in which the commodities income has been recognized may wish to accelerate the final year end distribution from the CFC.

The IRS has not been issuing private letter rulings on whether financial instruments that provide commodities exposure are securities for several years, so the Revenue Procedure is just a formalization of existing IRS practice. Funds that have obtained commodities exposure through financial instruments, such as commodity linked notes, will have already had to independently obtain comfort on their income and portfolios.

If the proposed rules are adopted, funds should review and potentially revise their disclosures.

Background: CFC Rules

In general, the offshore earnings of a foreign corporation are not subject to U.S. taxation unless the entity is engaged in a U.S. trade or business, the earnings of such foreign

corporation are distributed to a U.S. shareholder, or the earnings are deemed distributed to a U.S. shareholder under an anti-deferral regime. Subpart F is the primary anti-deferral regime applicable to the offshore earnings of foreign corporate subsidiaries.

If a RIC or another U.S. person wholly owns a foreign corporation, then the foreign corporation is a CFC. If the CFC has certain kinds of income called Subpart F income, then the RIC must include the CFC’s Subpart F income in its own gross income (“*Subpart F inclusions*”). If the CFC has other owners, the Subpart F rules still apply as long as the CFC is owned at least 50% by U.S. persons, but the RIC would only take its pro rata share of the CFC’s Subpart F income into its gross income.

Subpart F Income generally means passive income, including interest, dividends royalties, rents and annuities and the excess of the gains over losses from the sale or exchange of property (i) which gives rise to dividends, interest, royalties, rents and annuities, (ii) which is an interest in a trust, partnership or REMIC, or (iii) which does not give rise to any income.

Subpart F income also includes the excess of gains over losses from commodities. For these purposes, commodities include tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded.

Therefore, if a RIC owns stock in a foreign corporation that is owned at least 50% by U.S. persons and the foreign corporation has gains from commodities, then the RIC will be treated as receiving Subpart F income. In practice, the CFC will usually, but not always, pay an actual distribution in the same taxable year as the deemed Subpart F inclusion.

Background: RIC Qualifying Income

To qualify as a regulated investment company under the tax rules, certain tests must be satisfied. One test requires that at least 90 percent of the RIC's gross income is qualifying RIC income. Qualifying RIC income includes dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies. "Securities" is defined under the 1940 Act. Qualifying RIC income also includes "other income" derived with respect to the RIC's business of investing in such stock, securities or currencies.

Therefore, Subpart F income could be qualifying RIC income if it were categorized as "dividends" or as "other income" derived with respect to the business of investing in stock or securities.

The Internal Revenue Code states that income from a Subpart F inclusion is treated as a dividend to the extent that there is a matching distribution. Since a Subpart F inclusion with a matching distribution is treated as a dividend and a dividend is qualifying RIC income, a Subpart F inclusion with a matching distribution is qualifying RIC income.

The Code does not explicitly state whether Subpart F inclusions are qualifying RIC income to the extent there is not a distribution. However, prior to the new guidance, many tax practitioners have felt comfortable that Subpart F income inclusions without matching distributions were qualifying RIC income based on legislative history and a series of private letter rulings from the IRS. The legislative history indicated that mutual fund investments should not be unduly restricted and that income held for investment should normally be qualifying RIC income. Before 2011, the IRS repeatedly issued several private rulings recognizing that Subpart F income without distributions may be "other income" for the purposes of the RIC income test. However, in July 2011, the IRS announced a pause in these rulings while it reviewed the issues and considered broader guidance.

New guidance

The first piece of guidance that the IRS released last week related to the question of whether qualifying RIC income could include Subpart F distributions that RICs receive from CFCs when no matching distribution is made. The guidance consists of proposed regulations under Section 851.

The proposed regulations under Section 851 specify that, contrary to previously issued private letter rulings, a Subpart F inclusion without a distribution is not qualifying RIC income. More specifically, it provides that Subpart F inclusions are treated as dividends for purposes of RIC qualifying income "only to the extent" that there is a distribution out of the earnings and profits of the taxable year that are attributable to the amounts included in gross income for the taxable year under Subpart F.

The proposed regulations also state that Subpart F inclusions are not treated as "other income" derived with respect to a corporation's business of investing in stock, securities or currencies. This proposed exclusion from "other income" applies to taxable years that begin on or after the date that is 90 days after the date of publication in the Federal Register of a Treasury decision adopting the proposed regulations as final regulations.

The second piece of guidance, Revenue Procedure 2016-50, provides that the IRS ordinarily will not issue rulings or determination letters on any issue relating to the treatment of a corporation as a RIC that requires a determination of whether a financial instruments or position is a "security" under the 1940 Act. There is no similar prohibition on rulings for the question of whether income is a dividend or "other income" for purposes of the RIC rules. This rule applies to all requests submitted on or after September 27, 2016.

The IRS has issued two Revenue Rulings on the issue of whether financial products tied to commodities were securities. The first, Rev. Rul. 2006-1 concluded that a commodity index derivative contract was not a security. The second, Rev. Rul. 2006-33, provided that Rev. Rul. 2006-1 was not intended to preclude a conclusion that income from structured notes was qualifying income. Prior to 2011, the IRS issued many private letter rulings concluding that structured notes were securities. The preamble to the proposed regulations states that any future guidance regarding whether particular financial instruments are securities is within the jurisdiction of the SEC.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

Paul D. Carman

Chicago

312.845.3443

carman@chapman.com

Christie R. Galinski

Chicago

312.845.3431

galinski@chapman.com

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®

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