

Final Regs Reverse Proposed Mutual Fund Income Rules

by Emily L. Foster

Final regulated investment company rules clarify the treatment of subpart F and passive foreign investment company income inclusions, reversing Treasury and the IRS's 2016 proposed regulations.

Under final RIC regulations (T.D. 9851) issued March 18, the government adopted commentators' recommendations to treat subpart F income from controlled foreign corporations and qualified electing fund (QEF) income from PFICs as qualified RIC income, even if the foreign corporation doesn't make a distribution.

"The changes made in the final regulations are important because they ensure that funds can still invest in foreign companies, giving U.S. investors exposure to those securities, without jeopardizing their qualification as a regulated investment company," Karen Lau Gibian, associate general counsel for tax law at the Investment Company Institute, told *Tax Notes*.

The institute argued that the 'other income' proposal is 'unnecessary, arbitrary, and contrary to legislative intent.'

The institute had argued that the "other income" proposal in the 2016 proposed regs (REG-123600-16), "which would reclassify many subpart F and QEF inclusions as bad income, is unnecessary, arbitrary, and contrary to legislative intent."

Richard C. LaFalce of Morgan, Lewis & Bockius LLP pointed out how the IRS seems to have responded to what would have been an odd result under the proposed regs. He said that dividends and interests generated by a PFIC would be good income if they were received directly by a RIC. However, under the proposed rules, that wouldn't be the case for a PFIC with a QEF — for which the RIC made a QEF election — if the PFIC didn't make a current distribution out of earnings and profits to the RIC, LaFalce noted.

The Reversal

Under section 851(b), a RIC, commonly called a mutual fund, must meet specific election, gross income, and diversification requirements.

Section 851(b)(2) requires that a RIC derive at least 90 percent of its gross income from specific sources, including dividends, interest, gains from the sale or other disposition of stock, securities, or foreign currencies, and "other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities or currencies."

The final regs adopt the proposed rule that income inclusions under section 951 (for CFCs) and under section 1293 (for PFICs) will be treated as dividends for purposes of section 851(b)(2) only if actual distributions attributable to those inclusions are made.

The proposed rules would have also provided that an inclusion under section 951(a)(1) or 1293(a) (QEF rules) doesn't qualify as other income derived from a RIC's business of investing in stock, securities, or currencies.

In response to commentators' unanimous recommendations and concerns, Treasury and the IRS excluded that rule from the final regs, stating that the proposed rules would have created "an unintended effect on the RIC income test of section 851(b)(2)."

The final regs added a provision to "treat inclusions under sections 951(a)(1)(A) and 1293(a) derived with respect to a RIC's business of investing in stock, securities, or currencies as other qualifying income for purposes of the RIC income test." Taxpayers may rely on this rule for tax years beginning after September 28, 2016, although the final regulations are generally effective on the date the regulations are published in the *Federal Register*.

The New York State Bar Association recommended that rule change in its November 2016 comment letter.

Treasury and the IRS said the qualifying income rule was adopted after consideration of the issues raised and the provisions under the Tax Cuts and Jobs Act "affecting the taxation of income earned outside of the United States."

Prior Rulings Remain

The final regulations follow the proposed rule that for purposes of the income test and the asset diversification requirements, an asset is a security if it is a security under the Investment Company Act of 1940. The proposed regs explained that “any future guidance regarding whether particular financial instruments, including investments that provide RICs with commodity exposure, are securities for purposes of the 1940 Act is . . . within the jurisdiction of the SEC.”

The proposed regs requested comment on whether previous guidance regarding determinations of whether a financial instrument or position held by a RIC is a security under the 1940 act should be withdrawn when the regulations are finalized. A no-rule revenue procedure also from 2016 (Rev. Proc. 2016-50, 2016-43 IRB 522) provided that the IRS ordinarily won’t issue those types of rulings or determinations.

Treasury and the IRS decided in the final regs not to withdraw revenue rulings on determining whether an instrument or position held by a RIC is a security, citing commentators who the government claimed said that “RICs rely on those rulings to invest with confidence in certain derivatives on stocks and securities,” and that removing them would create confusion and uncertainty for RICs’ investments. ■