Excise Tax Relief for RICs Subject to the Transition Tax as Part of the 2017 Tax Reform

The Internal Revenue Service (the "IRS") recently provided excise tax relief for funds taxed as regulated investment companies ("RICs") that were required to increase their gross income because of the new Section 965 transition tax. Revenue Procedure 2018-47 (available here: https://www.irs.gov/pub/irs-drop/rp-18-47.pdf) allows calendar-year RICs that had to take an inclusion in income from accumulated earnings and profits in certain foreign corporations due to the transition tax under Section 965 of the Internal Revenue Code (the "Code") to treat the inclusion as if it were made in 2018 instead of 2017. Therefore, the matching required distribution to investors can be made in 2018 instead of 2017.

Background: RIC Distribution Requirements

RICs are required to make distributions under two separate rules. Under the RIC rules in Section 852, RICs must distribute 90 percent of their investment company taxable income to qualify as a RIC. Under the excise tax rules of Section 4982, RICs can avoid an excise tax by distributing 98 percent of their ordinary income and 98.2 percent of their capital gain net income. The excise tax is 4 percent of the amount of the required distribution that was not actually distributed.

To give taxpayers enough time to calculate their required distribution relating to capital gain net income, the required distribution for the calendar year is based on the capital gain income during the one-year period ending with October 31 of each tax year. Some items of ordinary income are also given this extra calculation time, such as foreign currency gains and certain passive foreign investment company income.

Tax Reform 2017: Transition Tax

New Section 965, which was implemented with 2017 Tax Reform (Tax Cuts and Jobs Act), required certain U.S. taxpayers with certain foreign subsidiaries to pay a transition tax based on the previously untaxed post-1986 foreign earnings and profits of those foreign subsidiaries. The new rule would increase the U.S. shareholder's subpart F inclusion, which is usually a yearly inclusion for passive income earned by a foreign corporation that is controlled by U.S. shareholders.

The transition tax is applicable to U.S. shareholders of controlled foreign corporations as well as U.S. shareholders of other foreign corporations with at least one 10-percent shareholder that is a U.S. corporation. A "U.S. shareholder" for this purpose means a U.S. person who owns 10 percent or more of a foreign corporation by vote or value. A "controlled foreign corporation" means a foreign corporation that is at least owned 50 percent by such U.S. shareholders.

Section 965 may also provide a deduction to a U.S. shareholder in the year that the U.S. shareholder has a 965 inclusion.

The Issue: Not Enough Time

2017 Tax Reform became law on December 22, 2017. The transition tax inclusion was to be made in the last taxable year of the foreign corporation that began before January 1, 2018. Therefore, if the taxable year of the foreign corporation is the calendar year, under the Code, the 965 inclusion should be taken into account by the RIC shareholder in the 2017 tax year. As a result, the RIC may only have had a few days in 2017 to prepare and calculate the correct required distribution amount to avoid the excise tax.

The Relief: Extension of Time

The IRS received requests for relief from taxpayers who cited the administrative burden of obtaining information from their foreign subsidiaries, computing the required amounts and making the required distribution in a limited amount of time. A 965 inclusion (which would be made at the end of 2017) would not qualify under the Code to be pushed to the next year like foreign currency gains or some other types of income received after October 31.

Therefore, the IRS provided relief in Revenue Procedure 2018-47 by stating that the IRS will not challenge a RIC's treatment of a 965 inclusion or deduction that occurred after October 31, 2017 as a gain or deduction for the 2018 tax year.

Therefore, a RIC may make a required excise tax distribution in 2018 for a transition tax inclusion that happened in 2017 without concern that the delay will cause an excise tax.

No New Relief for 90-percent Distribution Requirement Under 852

The revenue procedure does not explicitly provide new relief for the 90-percent distribution requirement for RIC qualification under Section 852, as described above. The two existing rules below provide relief under that requirement, but not for the excise tax under Section 4982. A separate rule would allow a dividend declared in December, but paid in January, to be treated as paid in December. However, that did not solve the need to calculate and declare the dividend in December.

First, if a dividend to RIC shareholders is declared and paid before certain dates, then the RIC can elect to treat the dividend as if it were paid in the preceding year for purposes of Section 852. This rule applies if the dividend is declared before the later of (1) September 15th for calendar year taxpayers (or 9 months and 15 days after the end of the taxpayer's tax year) or (2) in the case of a time extension for filing the tax return, the due date for filing such tax return, taking extensions into account. To qualify for the election, the dividend must also be paid before the earlier of (1) 12 months after the close of the taxable year or (2) the next dividend distribution of the same type.

Second, under Section 860, relief is provided regarding the distribution requirement in Section 852 in the event a RIC has to make an adjustment to its income because of a determination such as a court decision or closing agreement with the IRS. In that case, the RIC is allowed to make a later dividend, called a deficiency dividend, that will be taken into account in calculating whether the required distributions have been made in the year that the income adjustment was made.

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