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Client Alert

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March 12, 2014

Tax Reform Act of 2014 - Proposed Changes to RIC Related Provisions

Recently proposed legislation would generally (i) require sale treatment when a C corporation elects to become a regulated investment company ("RIC") or transfers assets to a RIC, (ii) treat certain RIC shares as United States real property interests subject to tax by non-U.S. persons on disposition, and (iii) provide that RIC dividends received through foreign corporations would not be eligible for a dividends received deduction.

On February 26, 2014, Representative David Camp, chair of the House Ways and Means Committee, released draft legislation referred to as the Tax Reform Act of 2014. The following is a summary of the proposed changes to the RIC provisions of the Internal Revenue Code included in the draft legislation. We have also prepared summaries of other provisions relevant to other topical areas - please check our website for those. Although the Tax Reform Act of 2014 has not yet been formally introduced as a bill, and its prospects for passage are uncertain at this point, given the significant nature of the proposed reforms, we will monitor their progress and provide updates as warranted.

Current Gain Recognition on RIC Election or Transfer of Assets to a RIC

Under current law, in general, if a C corporation converts to a RIC or transfers property to a RIC, the RIC is required to pay tax as if it were a C corporation upon any disposition of assets within 10 years after the conversion or transfer, based on the built-in gain at the time of conversion or transfer. Current law provides for an election to avoid the tax at the RIC level if the C corporation elects to recognize the built-in gain in full upon conversion or transfer.

Under the proposed legislation, if a C corporation elects to become a RIC, the corporation must recognize gain or loss as if all of its assets were sold by the corporation at their fair market value immediately before the close of the last taxable year before the corporation becomes a RIC. In addition, if a C corporation transfers one or more assets to a RIC the basis of which is determined by reference to the basis of such asset or assets in the hands of the C corporation (*e.g.*, a Section 351 transaction), the corporation must recognize gain or loss as if such assets were sold by the corporation at their fair market value as of the end of the day before the day of the transfer. For these purposes, a C corporation does not include a regulated investment company or a real estate investment trust. The basis of the assets to the RIC would be equal to the fair market value used for this purpose. However, if the application of these rules would result in the recognition of a "net loss," the rules will not apply. For this purpose, the term "net loss" is defined to mean the excess of aggregate losses over aggregate gains (including items of income) without regard to character. Accordingly, under the proposed legislation, sale treatment at the time of the RIC election or transfer of assets would be mandatory.

Certain RIC Shares Treated as United States Real Property Interests

Under current law, a tax is generally imposed on dispositions by foreign persons of "United States real property interests." In particular, the gain or loss is treated as effectively connected with a U.S. trade or business. A United States real property interest generally includes an interest in real property located in the United States and an interest in a United States corporation the assets of which, at any time during the five-year period preceding the disposition of the interest, consisted predominantly of United States real property interests. However, a United States real property interest does *not* include an interest in a corporation if (i) as of the date of the disposition of the interest, the corporation did not hold any United States real property interests and (ii) all of the United States real property interests held by the corporation during the five-year period preceding the disposition either (a) were disposed of in transactions in which the full amount of the gain (if any) was recognized or (b) ceased to be United

States real property interests. Under the proposed legislation, in addition to meeting the requirements of (i) and (ii) above, to qualify for the disposition-of-the-assets exclusion neither the corporation nor any predecessor of the corporation could be or have been a RIC at any time during such five-year period.

Note that the proposed legislation would not affect the provision under current law which provides that shares of stock that are regularly traded on an established securities market are not treated as United States real property interests in the case of any person who held 5 percent or less of such stock at all times during such five-year period.

RIC Dividends Received Through Foreign Corporations Excluded from Dividends Received Deduction

Under current law, dividends received by a corporation from a “qualified 10-percent owned foreign corporation” qualify for a deduction in an amount generally equal to a percentage of the U.S.-source portion of the dividends. In determining the U.S.-source portion of the dividends, dividends received by the foreign corporation from certain 80-percent owned domestic corporations are included as part of the calculation. Under the proposed legislation, RICs are not considered domestic corporations for this purpose. Accordingly, the dividends received deduction would not apply to dividends that are attributable to dividends received by the foreign subsidiary from a RIC.

The RIC provisions highlighted herein are the primary provisions of the proposed legislation affecting RICs. Note, however, that there are also various other provisions in the proposed legislation that would amend certain RIC related sections of the Internal Revenue Code as a result of conforming amendments.

For More Information

For more information, please contact Paul Carman (312.845.3443), Tony Rosso (312.845.3913), Colleen Kushner (312.845.3771), Colman Burke (415.278.9033), or Melanie Gnazzo (415.278.9020).

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