



1401 H Street, NW, Washington, DC 20005-2148, USA  
202/326-5800 www.ici.org

***By Electronic Delivery***

March 15, 2018

Chip Harter, Deputy Assistant Secretary, International Tax Affairs  
Tom West, Tax Legislative Counsel  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

RE: Application of Tax on Deferred Foreign  
Income to Regulated Investment Companies

Dear Mr. Harter and Mr. West:

The Investment Company Institute<sup>1</sup> and its members are concerned about the application to regulated investment companies (RICs) of the new transition tax on deferred foreign income in section 965, as amended by Pub. L. No. 115-77 (the Act). RICs, as corporations, are subject to the new rules to the extent that they own 10 percent or more of a foreign corporation. The Act, however, does not address how such amounts impact a RIC's qualification tests and distribution requirements under Subchapter M or the application of the excise tax rules under section 4982.

If these rules are not clarified, the consequences to RICs and their investors could be significant, resulting in entity-level income and excise tax as well as increased taxable ordinary and capital gain dividends to shareholders. We thus ask the Treasury Department and the Internal Revenue Service (IRS) to exercise the authority granted under sections 965(o) and 7805(a) to:

- (1) Clarify that any deferred income should be ignored or treated as qualifying income for purposes of the RIC income qualification requirements in Subchapter M;

---

<sup>1</sup> The [Investment Company Institute](http://www.ici.org) (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$22.5 trillion in the United States, serving more than 100 million US shareholders, and US\$7.5 trillion in assets in other jurisdictions. ICI carries out its international work through [ICI Global](http://www.ici.org/global), with offices in London, Hong Kong, and Washington, DC.

- (2) Permit RICs to elect to include such income over the eight-year period available to other taxpayers for both income and excise tax purposes, thus spreading the required distribution of such amounts over the same period;
- (3) Clarify that a RIC's share of deferred foreign income from a specified foreign corporation with a calendar year-end is treated as arising on January 1, 2018, for purposes of section 4982 and thus is first included in excise tax calculations for 2018, not 2017; and
- (4) Provide relief for all taxpayers in situations in which the foreign corporation will not or cannot provide the information necessary for a RIC or other US shareholder to determine its share of any deferred foreign income under US tax principles.

### *Tax on Deferred Foreign Income*

The Act provides rules intended to transition taxpayers from the current worldwide system of taxation to a participation exemption system. Amended section 965 generally requires a US shareholder (including a RIC) that owns 10 percent or more of a foreign corporation to include as current income (specifically, as a "subpart F inclusion" under section 951(a)(1)) its pro rata share of the foreign corporation's post-1986 undistributed accumulated earnings and profits for its last taxable year beginning before January 1, 2018. This mandatory subpart F inclusion is subject to a participation exemption, resulting in tax on the inclusion at rates of 15.5 percent, if attributable to the foreign corporation's cash position, or 8 percent, if attributable to the foreign corporation's other positions. US shareholders are permitted to pay the net tax liability resulting from the subpart F inclusion over an eight-year period.

Amended section 965(m) provides special rules for real estate investment trusts (REITs). Any deferred foreign income that must be included in income under this provision is not taken into account for purposes of the REIT gross income qualification test under Subchapter M. REITs also may elect to include such income over the eight-year period available to other taxpayers, thus permitting REITs to distribute the income to the REIT shareholders over the same period.

### *Application to RICs*

Although RICs and REITs are subject to similar rules under Subchapter M,<sup>2</sup> the Act does not provide any special rules under section 965 for RICs. This might seem inconsequential, as RICs typically do not own more than 10 percent of a foreign corporation that is not a wholly owned controlled foreign corporation (CFC). We are aware of several funds, however, that own more than 10 percent of specified foreign corporations and thus are subject to section 965.

---

<sup>2</sup> Both RICs and REITs, for example, are subject to certain income and asset qualification tests.

The application of the section 965 rules to RICs raises several questions. Without appropriate clarification, the consequences for both RICs and their shareholders will be significant.

### RIC Income Qualification Test

Under the qualifying income test in section 851(b)(2), at least 90 percent of a RIC's gross income must be derived from dividends, interest, gains from the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investing in such stock, securities, or currencies. RICs commonly have treated Subpart F income inclusions from CFCs under section 951(a)(1)(A) and income inclusions under section 1293(a) from passive foreign investment companies (PFICs) that are qualified electing funds (QEFs) as "other income" and thus qualifying income under section 851.<sup>3</sup>

Recently proposed regulations would invalidate the treatment of such Subpart F income and QEF inclusions as qualifying income in the absence of an actual distribution from the CFC or PFIC.<sup>4</sup> Specifically, the proposed regulations relate to the flush language of section 851(b), which states that amounts included in gross income under section 951(a)(1)(A) or 1293(a) shall be treated under section 851(b)(2) as "dividends" for the tax year "to the extent that there is a distribution out of the earnings and profits of the tax year which are attributable to those amounts."

The proposed regulations would clarify that Subpart F and QEF inclusions are "dividends" for purposes of section 851 only to the extent that the CFC or PFIC has made a distribution out of its earnings and profits. The proposed regulations also would provide that such inclusions are not treated as "other income" under section 851(b)(2). Thus, the proposed regulations would provide that Subpart F and QEF inclusions do not qualify as "good income" unless the foreign corporation has made an actual distribution attributable to those amounts.

The new Subpart F inclusion required by section 965 will create additional concerns for RICs if the proposed regulations apply, given the unlikelihood that a distribution will accompany such inclusion.<sup>5</sup> If the inclusions are treated as "non-qualifying" income, it will have significant implications for RICs and shareholders.<sup>6</sup> Specifically, if the amount included exceeded 10 percent of the RIC's total gross income, this could jeopardize the RIC's qualification under

---

<sup>3</sup> If the Subpart F or QEF inclusion is accompanied by a distribution out of the foreign corporation's associated earnings and profits, the inclusion would be considered a "dividend" pursuant to the flush language in section 851(b).

<sup>4</sup> Prop. Reg. § 1.851-2(b)(2).

<sup>5</sup> In most cases to which section 965 applies, a RIC will be invested in an unrelated specified foreign corporation. As a portfolio investor, the RIC typically will not be able to influence the issuer to make that type of distribution.

<sup>6</sup> Similar concerns arise with respect to amounts included in income under the new global intangible low-taxed income (GILTI) regime. Section 951A (f) treats GILTI as Subpart F income for purposes of section 851(b).

Subchapter M. If the RIC lost its qualification, it would be subject to tax at the corporate level on all its income. In addition, investors would lose the tax benefits of various “flow-through” provisions provided by subchapter M. We do not believe that this is the right or intended result, particularly as the consequences would be detrimental to both RICs and their shareholders.

The Institute and its members strongly disagree with the IRS’s interpretation of the “other income” provision in the proposed regulations and believe that Subpart F inclusions (including those under section 965) and QEF inclusions should be considered “good income” in the absence of a distribution.<sup>7</sup> Even if the proposed regulations generally were correct, the one-time, transitional inclusions under section 965, which came into scope only with the Act’s signing on December 22, 2017, should constitute “other income” derived with respect to the RIC’s investment in the foreign corporation.

Therefore, we ask the Treasury Department and the IRS to clarify that Subpart F inclusions under section 965 will not be included for purposes of the gross income test under section 851(b), as the Act similarly provides for REITs. Alternatively, if such amounts should be included in gross income for purposes of the Subchapter M qualification requirements, the Treasury Department and the IRS should clarify that section 965 Subpart F inclusions will constitute “other income” in the absence of distributions.<sup>8</sup>

#### Distribution and Impact on Shareholders

One of the benefits of a RIC as an investment vehicle for moderate-income individuals is that it pays little or no tax at the corporate level, if it satisfies the qualification tests under section 851 and the distribution requirements under section 852. Mechanically, RICs receive a dividends paid deduction (DPD) under section 561 for any dividend distributions made to shareholders. Section 852(a) requires a RIC to distribute at least 90 percent of its income and gains for its fiscal year, generating a DPD for those amounts, to qualify as a RIC under Subchapter M. Any amount retained by the RIC above the 90 percent will be subject to a RIC-level tax.

Additionally, RICs are subject to a 4 percent excise tax under section 4982 if they do not distribute 98 percent of their ordinary income and 98.2 percent of their capital gains (measured through October 31) for the calendar year, plus any amounts not distributed in the prior calendar year. Because of the Subchapter M and excise tax distribution requirements, RICs generally distribute substantially all their income and gains annually.

---

<sup>7</sup> See Institute Letter to William Wilkins and Tom West, dated December 22, 2016 (arguing that tax policy and legislative history indicate that such inclusions should be treated as “other income” in the absence of a distribution).

<sup>8</sup> As noted in the Institute’s December 22, 2016 letter, we believe that this is the correct answer with respect to all Subpart F and QEF inclusions and strongly urge the government to consider withdrawing the proposed regulations.

Section 965 Subpart F inclusions will impact a RIC's distribution requirements, and that impact will be more significant if the RIC must include the total amount of its share of deferred foreign income in the first year. If the RIC's pro rata share equals 10 percent or less of the RIC's taxable income for the fiscal year, the RIC is not required to distribute those amounts to its shareholders, but it must pay tax on such amounts at the entity level. If the amount exceeds 10 percent, the RIC must distribute the amount of deferred foreign income that exceeds the 10 percent threshold to satisfy the Subchapter M qualification requirements. Given that RICs generally distribute all of their taxable income to shareholders annually to avoid paying taxes at the entity level, most RICs likely would distribute any such deferred foreign income to shareholders. Shareholders, in turn, would receive ordinary dividends that would be subject to tax. Depending on the amount of a RIC's Subpart F inclusion under section 965, RIC shareholders could experience a significant and unexpected spike in the RIC's distributions and their tax liability for the year of inclusion.

In addition, because the foreign corporation likely will not make an actual distribution with respect to the RIC's inclusion, the RIC may be forced to sell securities to generate enough cash to pay the dividends to its shareholders. Any capital gains on the sale of those securities also must be distributed to the shareholders, resulting in even larger taxable distributions for the year of inclusion.

The excise tax distribution requirements may be more problematic, as RICs are required to distribute 98 percent of ordinary income each calendar year. If all of a RIC's share of deferred foreign income must be taken into income in the first year, this will put more pressure on a RIC's ability to meet the excise tax distribution because the cushion is much smaller. Again, the distribution to shareholders will be taxable as an ordinary dividend, and the shareholders also may be subject to additional capital gains tax to the extent that the RIC must sell securities to generate cash to pay the distribution.

REITs have similar distribution requirements. To address the difficulties described above, the Act permits REITs to elect to include in income any Subpart F inclusions under section 965 over an eight-year period; this benefit reduces the amount that REITs must distribute to shareholders in any given year. The same rule should apply to RICs. Further, because RICs and their shareholders are not eligible for the section 245A participation exemption for dividends from specified foreign corporations, RIC shareholders, many of whom are middle-income individuals, will be taxed on this subpart F income a second time when the specified foreign corporation pays dividends in respect of that income. Permitting RICs to spread the income inclusion over eight years, as REITs are permitted, would minimize the burden of this double-tax effect.

#### Year of Inclusion for Excise Tax

As discussed above, RICs are subject to an excise tax under section 4982. Ordinary income generally is measured on a calendar-year basis because the most common forms of

ordinary income (e.g., interest and dividends) typically are periodic and predictable. The Internal Revenue Code, however, provides an October 31 cut-off for capital gains because the realization of capital gains and losses is difficult to predict. Operationally, RICs must determine the amount of and make excise distributions prior to December 31; in the absence of an early cut-off for capital gain net income, a RIC that realized significant late-year capital gains or losses inadvertently could distribute too much or too little.

In addition to capital gains, there are many provisions that give rise to ordinary income and loss that can create similar estimation issues for RICs with respect to amounts realized late in the calendar year. To provide some relief to RICs from having to estimate and distribute certain unpredictable, hard-to-estimate late-year income and losses by December 31, Congress enacted the “push” rules of section 4982(e)(5). These rules provide that “specified gains and losses” arising after October 31 of a calendar year shall be treated as arising on January 1 of the following calendar year for excise tax purposes.<sup>9</sup> Similarly, section 4982(e)(6) provides that any provision that treats a position as sold on the last day of the taxable year (a “specified mark-to-market provision”) is applied on October 31 instead of December 31.

Section 965 provides that a foreign corporation’s post-1986 deferred foreign income is calculated as of November 2, 2017, or December 31, 2017, whichever is greater, and is included as Subpart F income for the last taxable year of the foreign corporation that begins before January 1, 2018. Thus, for example, a specified foreign corporation with a calendar year includes the deferred foreign income in its Subpart F income for its taxable year ending December 31, 2017. Under section 951, each US shareholder of that foreign corporation then generally must include the Subpart F income in the shareholder’s taxable year in which or with which the foreign corporation’s applicable tax year ends. Therefore, a RIC investing in a specified foreign corporation with a calendar tax year would include its Subpart F income under section 965 in the RIC’s taxable year that includes December 31, 2017. For example, a calendar-year RIC investing in a calendar-year specified foreign corporation would include its share of the Subpart F income in its tax year ending December 31, 2017. A RIC with a taxable year ending June 30 that invests in the same specified foreign corporation would include its share of the Subpart F income in its tax year ending June 30, 2018.

The interaction of the timing rules under the Act and the excise tax rules of section 4982 potentially could require any RIC investing in a calendar-year specified foreign corporation to include the Subpart F income in its excise tax calculations for 2017, regardless of the RIC’s taxable year. Under section 4982(e), a RIC’s ordinary income for excise tax purposes generally is determined by treating the calendar year as the RIC’s taxable year. The calendar-year specified foreign corporation’s year ending December 31, 2017, thus ends with or within a RIC’s

---

<sup>9</sup> Ordinary gains and losses from the sale, exchange, or other disposition of property (including the termination of a position with respect to such property) that a RIC realizes between November 1 and December 31 are referred to as “specified gains and losses.” This includes section 988 gains and losses and PFIC gains and losses under section 1296.

excise tax year ending December 31, 2017. This means that a RIC could be required to include its section 965 Subpart F inclusions in determining its 2017 excise requirements.<sup>10</sup>

Given the timing of the passage of the Act, however, there was no practical way for RICs to have identified and addressed this issue by the end of the 2017 excise tax year. Thus, if the section 965 Subpart F inclusion must be included in a RIC's 2017 excise tax year, RICs that are subject to section 965 may have under-distributed for excise tax purposes and thus would be subject to an excise tax for 2017. This is especially true if all of the deferred foreign income must be included in the first year.

We urge the Treasury Department and the IRS to treat the Subpart F inclusion under section 965 for calendar-year specified foreign corporations as arising on January 1, 2018, given that, similar to specified gains and losses under section 4982(e)(5), these income amounts unexpectedly arose just prior to the excise tax year-end and are difficult to calculate. RICs that have such income thus should be permitted to include the Subpart F inclusion in their 2018 excise tax calculations and distribute the income for the 2018 excise tax year. Further, if RICs are permitted to elect to take such inclusions into income over an eight-year period, such income should be treated as arising on January 1 of each subsequent year.

#### Calculation of Deferred Foreign Income

RICs usually purchase shares in foreign corporations (other than wholly owned CFCs) on stock exchanges and simply hold those shares as portfolio investors. As such, it may be difficult for RICs and other US investors to determine the foreign corporation's deferred foreign income under this provision. It would require the foreign corporation to agree to either calculate that amount itself under US tax principles over a 20-year period or to provide information sufficient for the US shareholders to do so independently.<sup>11</sup> Further, it would require the foreign corporations to provide sufficient information to an investing RIC to determine what, if any, years it may have been a PFIC or otherwise did not qualify as a specified foreign corporation (e.g., because it had no US shareholders).

It is not clear how viable this will be. The foreign corporations generally are not legally obligated to provide this type of information to a RIC or other portfolio investor and therefore may be unwilling to provide all or part of this information. Further, given the burden and

---

<sup>10</sup> Specified foreign corporations with non-calendar year-ends do not pose the same problem because the section 965 Subpart F income would arise in the RIC's 2018 excise tax year. For example, if the specified foreign corporation has a January 31 year-end, the foreign corporation's taxable year would end within the RIC's 2018 calendar-year excise tax year ending on December 31, 2018. The RIC thus would include the section 965 Subpart F inclusion in income for the 2018 excise tax year.

<sup>11</sup> RICs face the same problems with respect to PFICs. In fact, the mark-to-market rules in section 1296 were enacted in large part because RICs generally lacked access to the information about a portfolio investment necessary to make a QEF election.

complexity associated with calculating these amounts, a foreign company simply may not have the resources to provide all of the needed information.

Therefore, the amount that a RIC includes in income may be incorrect, even when using best efforts to collect and calculate the RIC's pro rata share of the foreign corporation's deferred foreign income. If it is later determined that the amount the RIC included in income is incorrect, this could have implications both for income qualification purposes under section 851 and for the RIC's distribution requirements under sections 852 and 4982, as described above.

We thus ask the Treasury Department and the IRS to provide relief to US shareholders, including RICs, who have used reasonable efforts to determine their section 965 Subpart F inclusions. It would be unfair to penalize such taxpayers to the extent that they are unable to gather the information necessary to accurately calculate their tax liability.

#### *Recommendation*

The Treasury Department and the IRS have broad regulatory authority under section 965(o) to issue regulations or other guidance "as may be necessary or appropriate to carry out the provisions of this section." The Treasury Department and the IRS also have authority under section 7805(a) to provide guidance as may be necessary due to any alteration to the tax laws. We urge the government to exercise this authority to address the application of section 965 to RICs. Specifically, the guidance should:

- (1) Clarify that any deferred foreign income should be ignored or treated as qualifying income for purposes of the RIC qualification requirements in Subchapter M, as it is for REITs;
- (2) Permit RICs to elect to include such income over the eight-year period available to REITs, for both income and excise tax purposes, thus spreading the required distribution of such amounts to RIC shareholders over the same period;
- (3) Clarify that a RIC's share of deferred foreign income from a calendar year-end specified foreign corporation is treated as arising on January 1, 2018, for purposes of section 4982 and thus is included in excise tax calculations for 2018, not for 2017;<sup>12</sup> and
- (4) Provide relief for all taxpayers that are US shareholders, including RICs, who have used reasonable efforts to gather the information necessary to determine their section 965 Subpart F inclusion amounts, if such amounts later are determined to be incorrect.

---

<sup>12</sup> If a RIC elects to include the income over the eight-year period, such income from a calendar-year specified foreign corporation should be treated as arising on January 1 of each such year, beginning with January 1, 2018.

Providing such guidance will alleviate the myriad problems that will arise from the application of section 965 to RICs.

We appreciate your attention to these matters. We will contact your offices to schedule a meeting to discuss them further; in the meantime, please do not hesitate to contact me (202-371-5432 or kgibian@ici.org) if you have any questions.

Sincerely,

*/s/ Karen L. Gibian*

Karen Lau Gibian  
Associate General Counsel, Tax Law

cc: Doug Poms  
Michael Novey  
William Paul  
Helen Hubbard  
Marjorie Rollinson