TAX REFORM AND INVESTMENT MANAGEMENT: EFFECT ON REGISTERED INVESTMENT COMPANIES

Date: 6 February 2018

U.S. Tax and Investment Management Alert

By: Joel D. Almquist, Virginia Leggett Stevenson, Mary Burke Baker, Theodore L. Press, John D. Price, Abigail F. Williams

The Tax Cuts and Jobs Act ("**Act**") significantly changed U.S. tax federal law. Although the Act does not amend any of the provisions directly affecting the qualification or other taxation of a "regulated investment company" (as defined in section 851(a) of the Internal Revenue Code of 1986, as amended ("**Code**") (a "**RIC**")), in Subchapter M, Chapter 1, Subtitle A of the Code, the Act does change the taxation of entities in which many RICs invest, the tax treatment of income derived from those entities, and the taxation of investors in RICs, not only individuals and corporations but also retirement plans, so-called 529 plans, partnerships, and foreign investors. The impact on RICs and those entities and investors of many of the Act's provisions, which are quite complex and, unlike major income tax bills in the past, were drawn somewhat hastily, are unclear and will have to await technical corrective legislation or interpretive guidance from the Internal Revenue Service ("**IRS**"), or both. (Unless otherwise noted, the provisions discussed below are effective for calendar-year taxpayers for taxable years beginning after December 31, 2017.)

Limitation on deductibility of business interest. The deduction for "business interest" of a corporation — a RIC is treated as a corporation under the Code — and other entities that engage in a trade or business in which many RICs invest is limited for any taxable year beginning after December 31, 2017. The deduction generally is limited to the sum of a taxpayer's "business interest income" (which expressly excludes "investment interest income") plus 30% of its "adjusted taxable income" — which is defined to mean taxable income without regard to, among other things, any deduction "not properly allocable to a trade or business" — for the year. Nondeductible business interest expense generally may be carried forward indefinitely, except in the case of partnerships, which are subject to certain additional special rules. Although this limitation, as written, applies to RICs, as corporations, *it may be possible that future guidance will (1) exclude RICs,* as "investment" companies and thus not "engaged in a trade or business," *from application thereof and/or (2) permit a RIC to not have to take into account in determining its adjusted taxable income the dividends-paid deduction* (which enables a RIC to fully offset its taxable income and net capital gain) because it is a deduction "not properly allocable to [its] trade or business."

Changes in taxation of non-corporate entities. Effective for taxable years beginning after December 31, 2017, and before January 1, 2026 ("**Change Period**"), the Act (in general terms) allows certain noncorporate entities, such as partnerships (including limited liability companies classified as such) and "S" corporations, a deduction for 20% of the sum of the taxpayer's "qualified business income" — which is the net amount of items of income, gain, deduction, and loss with respect to its trade or business — plus the aggregate amount of its qualified real estate investment trust ("**REIT**") dividends and "qualified publicly traded partnership income" ("**QPTPI**") (the latter including income of a publicly traded partnership that is not treated as a corporation for federal income tax purposes, such as a master limited partnership ("**MLP**")). Unlike the treatment of somewhat similar items, such as "qualified dividend income," dividends eligible for the corporate dividends-received deduction (see below), "exempt-interest dividends," "interest-related dividends," "short-term capital gain dividends," and foreign taxes paid, however, *the Act does not include any provision for a RIC to pass the character of its qualified REIT dividends and QPTPI through to its shareholders.*

Timing of inclusion of income for accrual basis taxpayers. Unless an exception applies, an accrual basis taxpayer must include an item of income in gross income when all events have occurred that fix the right to receive that income and the amount thereof can be determined with reasonable accuracy (the "all events test"). Generally, under the Act the all events test is treated as met with respect to any income item no later than when it is taken into account as revenue in a financial statement of the taxpayer. In addition to other types of income, this provision will apply to income from original issue discount ("**OID**") and market discount on loans and mortgage-backed securities. Significantly, however, according to the Conference Report on the Act this provision does not revise the rules associated with the time an item is realized for federal income tax purposes and, accordingly, does not require income recognition in situations where the realization event has not yet occurred; for example, this provision does not require the recognition of gain or loss from securities that are marked-to-market for financial reporting purposes if the gain or loss from them is not realized for federal income tax purposes until the taxpayer disposes of them. It is unclear how this change will affect RICs that invest in fixed-income securities that have OID or market discount (which must be accrued currently for accounting purposes but need not be recognized as income for federal income tax purposes until disposition of the security); *if applied to RICs that invest in municipal bonds, they might be required to recognize taxable market discount income currently*. This provision is effective for taxable years beginning after December 31, 2018, for income from a debt instrument having OID, and for taxable years beginning after December 31, 2017, for other types of income.

FOREIGN-RELATED PROVISIONS:

Repatriation of deferred foreign income. Prior to the Act, U.S. corporations, U.S. citizens, and resident individuals were taxed on their worldwide income. Under the Act, a 100% deduction is allowed for the foreign-source portion of dividends domestic corporations receive from certain 10%-owned foreign corporations. A U.S. shareholder, including a RIC, of such a corporation generally must include in income for the latter's last taxable year beginning before 2018 the shareholder's *pro rata* share of the corporation's earnings and profits ("**E&P**") accumulated after December 31, 1986, to the extent the E&P has not previously been subject to federal income tax. While the Act provides that such income will not be taken into account for purposes of the REIT qualifying income requirement (which, like many other REIT qualification requirements, is similar to the requirement applicable to RICs), it did not address this issue with respect to RICs. *Therefore, it is unclear how the deemed repatriation of deferred foreign income may affect a RIC that is a 10% shareholder of a foreign corporation.*

Controlled foreign corporation rules. A U.S. person that is a 10% shareholder (a "**United States shareholder**") of a controlled foreign corporation ("**CFC**") must include in gross income its pro rata share of the CFC's "**Subpart F income**." (Many RICs are the sole shareholder in a foreign subsidiary to gain exposure to investments in commodities.) Constructive ownership rules are used to attribute ownership of a foreign corporation's stock. Prior to the Act, those rules could not be applied to treat a U.S. person as owning stock that was owned by a foreign person. Under the Act, however, stock a foreign person owns is now treated as owned by a U.S. person in applying those rules. *As a result, a RIC's ownership of stock of a foreign corporation that itself owns stock of another foreign corporation could cause the RIC to be treated as a United States shareholder of a CFC* and thus be required to include in its gross income its pro rata share of the CFC's Subpart F income.

Prior to the Act, a "United States shareholder" was generally defined as any U.S. person (including a U.S. partnership) that owns (or is deemed to own) 10% or more of the total combined voting power of all classes of the foreign corporation's voting stock. The Act revises the definition to include a U.S. person who owns at least 10% of the value of the foreign corporation's stock. Additionally, the Act expands the types of income that a United States shareholder must include in gross income (whether or not distributed). Under the Act, a United States shareholder must include not only Subpart F income but also a new type of income referred to as "global intangible low-taxed income" or "**GILTI**." In general, GILTI includes all net operating income (taking into account allocable interest deductions) of a foreign corporation not otherwise taxed to United States shareholders in excess of a 10% return on the adjusted basis in the corporation's tangible assets used in the production of that income. Although a deduction is available to "C" corporations with respect to GILTI, which reduces the federal income tax impact of the GILTI provisions, that deduction is not available to RICs. *As a result, the universe of foreign corporations that create includable income for United States shareholders, and the amount thereof, under the CFC rules has expanded.*

Withholding on a foreign partner's disposition of a partnership interest. The Act has also created a new withholding provision with respect to such a disposition after December 31, 2017. (See our Alert on this topic.) Pursuant to that provision*, a RIC that purchases a partnership interest (such as an interest in an MLP or a limited liability company taxed as a partnership) may be required to withhold and remit to the IRS tax on account of the transferee*. The Act contemplates regulatory guidance for this requirement. It is possible that such guidance may allow for withholding to be done by brokers.

DISCLOSURE IN FUND PROSPECTUSES:

The reduction in individuals' federal income tax rates (see below) will need to be taken into account in calculating after-tax returns in the average annual total return tables in fund prospectuses. In addition, disclosures about and internal procedures for backup withholding, which is based on the fourth-lowest marginal rate for individual taxpayers, should reflect that the applicable rate has been reduced from 28% to 24%.

Because the Act does not provide for a RIC that invests in REITs and MLPs to pass through to its shareholders the deduction for REIT dividends and QPTPI, while an investor who invests directly therein would have the benefit of the deduction, query whether such a RIC needs to disclose that difference.

CHANGES AFFECTING INVESTORS IN RICS:

Individual income tax rates. Effective for the Change Period, the federal income tax rates for individuals change by reducing the marginal rate for each bracket other than the 10% (lowest) bracket, including reducing the top bracket from 39.6% to 37%. Following the sunset of this reduction after 2025, the pre-Act tax brackets and rates will apply.

Corporate income tax rate. Effective for taxable years after December 31, 2017, the Act eliminates the current graduated corporate income tax rate structure, with the maximum rate of 35%, and replaces them with a flat 21%

rate. Unlike the reduction of individual income tax rates, the reduction in the corporate tax rate is permanent (*i.e.,* does not sunset).

Prior to the Act, a corporation was generally entitled to a 70% deduction for dividends received from another corporation (an 80% deduction for dividends received from a 20%-or-more-owned corporation). Under the Act, those percentages have been reduced 50% and 65%, respectively.

Limitation on individuals' deductions. Effective for the Change Period, the Act (1) limits an individual's itemized deduction for state and local income taxes and property and sales taxes not incurred in carrying on a trade or business ("**SALT**") to a maximum of $10,000 (in the aggregate), *which limitation may affect individuals' demand for shares of municipal bond funds, and (2) suspends miscellaneous itemized deductions, which include individual investment expenses.*

The interest paid for borrowing for public purpose state and local bonds is still generally tax free. The Act preserves the gross income exclusion for interest paid on state and local governmental bonds issued to finance public purposes, as well as on qualified private activity bonds. For advance refunding bonds issued after December 31, 2017, however, the exclusion for interest on a bond issued to advance another refund bond is repealed. Interest from private activity bonds is still a preference (i.e., add-back) item for the individual alternative minimum tax, so *this repeal, combined with the limitation on SALT deductions, may affect investor demand for various products (e.g., for shares of triple-tax free bond funds).*

Regulatory guidance, and possibly legislative technical corrections, on the application of unclear or incomplete items is expected throughout 2018. We will keep you updated as and when any such developments occur. If you have questions or suggestions about any of these provisions, this is an opportune time to provide input to the Treasury Department, the IRS, and/or Congress, to maximize the chances that your concerns and comments will be addressed in a timely manner. The K&L Gates tax and policy teams stand ready to discuss how the rules may apply and to assist in developing comments and suggestions to inform the regulatory and legislative process.

KEY CONTACTS

JOEL D. ALMQUIST
PARTNER

BOSTON
+1.617.261.3104
JOEL.ALMQUIST@KLGATES.COM

VIRGINIA LEGGETT STEVENSON
PARTNER

CHARLOTTE
+1.704.331.7512
VIRGINIA.STEVENSON@KLGATES.COM

MARY BURKE BAKER
GOVERNMENT AFFAIRS COUNSELOR

WASHINGTON DC
+1.202.778.9223
MARY.BAKER@KLGATES.COM