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Treasury Issues Final Regulations Reversing Proposed Rules on Mutual Funds' Investments in Non-U.S. Corporations

On March 18, 2019, the Treasury Department and IRS issued final regulations (the “Final Regulations”), which treat certain income imputed to a regulated investment company (“RIC”) from its investment in a controlled foreign corporation or a passive foreign investment company as “good income” for RIC qualification purposes. Under the Final Regulations, a RIC may treat such imputations as “good income” even if the controlled foreign corporation or passive foreign investment company, as applicable, does not make a contemporaneous distribution that is attributable to the imputed income. This reverses the approach the Treasury Department and IRS took in proposed regulations issued on September 28, 2016 (the “Proposed Regulations”),¹ which would have treated the income as “good income” only when accompanied by such a contemporaneous distribution.

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Background on RIC Qualification, CFCs and PFICs

A RIC, commonly known as a mutual fund, generally is not subject to federal income tax at the fund level on income and gains that it timely distributes to shareholders. To qualify for treatment as a RIC under Subchapter M of the Internal Revenue Code of 1986, as amended (the “Code”), a fund must, among other things, derive at least 90% of its gross income from sources specified in Section 851(b)(2) (such income, “Good Income”). Good Income includes, among other things, dividends and other income derived with respect to the RIC’s business of investing in such stock, securities, or currencies (such other income, “Other Income”).

A RIC that owns (directly, indirectly or constructively) 10% or more of the total combined voting power of all classes of stock of a foreign corporation or 10% or more of the total value of shares of all classes of stock of a foreign corporation is a “U.S. Shareholder” of such foreign corporation.² If a RIC is a “U.S. Shareholder” of a controlled foreign corporation (a “CFC”),³ the RIC will generally be required to include in gross income its pro rata share of the CFC’s “subpart F income”⁴ whether or not such income is distributed by the CFC (“Subpart F Imputations”).⁵

A similar set of rules applies to the taxation of income and gains from investments in a passive foreign investment company as defined in Section 1297 (a “PFIC”). Under these rules, a U.S. person that is a shareholder of a PFIC may elect to treat the PFIC as a qualified electing fund (a “QEF”) and thereby recognize its share of the PFIC’s ordinary earnings and net capital gain (“QEF Imputations”).⁶

Income from CFCs and PFICs as Good Income in Absence of Repatriation

The Final Regulations adopt the proposed rule that Subpart F Imputations and QEF Imputations will be treated as dividends for purposes of the Good Income Test only if the CFC or PFIC, as applicable, makes actual contemporaneous distributions attributable to those imputations. The Proposed Regulations, however, also provided that dividend treatment

¹ Notice of Proposed Rulemaking, *Guidance under Section 851 Relating to Investments in Stock and Securities*, REG-123600-16, 81 Fed. Reg. 66576 (Sept. 28, 2016).

² Section 951(b).

³ As defined in Section 957.

⁴ As defined in Section 952.

⁵ Section 951(a)(1)(A). Section 951A imputes “global intangible low-taxed income” as defined in Section 951A(b) (“GILTI Imputations”) to a U.S. Shareholder of any CFC. Pursuant to Section 951A(f)(1)(A), for purposes of the Good Income Test, GILTI Imputations are treated as Subpart F Imputations.

⁶ Sections 1293 through 1295.

was the only manner in which a Subpart F Imputation or QEF Imputation could be Good Income. Specifically, under the Proposed Regulations, the Treasury Department and IRS took the approach that Subpart F Imputations and QEF Imputations did not qualify as Other Income and thus were Good Income only to the extent a CFC or PFIC, as applicable, made actual distributions attributable to the imputations.

In response to comments received following the release of the Proposed Regulations, the Final Regulations reverse the approach of the Proposed Regulations. The Final Regulations provide that, to the extent not treated as dividends as explained above, Subpart F Imputations and QEF Imputations derived with respect to a RIC's business of investing in stock, securities, or currencies are Other Income and, as such, Good Income. The Final Regulations state that a taxpayer may rely on this Other Income rule for taxable years that begin after September 28, 2016.

Implications for Commodity Subsidiaries

In many cases, a RIC's Subpart F Imputations arise from its investment in a wholly owned foreign corporate subsidiary that trades in commodities. Prior to issuance of the Proposed Regulations, the IRS issued a number of private rulings in which it took the position that Subpart F Imputations from such commodity subsidiaries were Other Income, and as such, Good Income, regardless of whether the CFC made actual distributions out of its earnings and profits attributable to the Subpart F Imputation.⁷ The Proposed Regulations had reversed this position, but in the Final Regulations the IRS again takes the position that a RIC may treat Subpart F Imputations from a commodity subsidiary as Good Income in the absence of actual distributions by the commodity subsidiary.

Final Regulations Reaffirm Prior Guidance on Definition of a Security

Finally, the Treasury Department and IRS had previously announced that it would not issue rulings or determination letters concerning whether a financial instrument or position is a security under the Investment Company Act of 1940 (the "1940 Act").⁸ The preamble to the Final Regulations reaffirms this position and further confirms the decision by the IRS not to withdraw earlier guidance on determining whether a financial instrument or position held by a RIC is a security under the 1940 Act.

⁷ See, e.g., I.R.S. Priv. Ltr. Rul. 201122012 (June 3, 2011) ("we rule that subpart F income of the [CFC] attributable to the [RIC] is income derived with respect to [RIC's] business of investing in the stock of [CFC] and thus constitutes qualifying income under [section] 851(b)(2), without regard to whether that income is distributed by [CFC] to the [RIC]"); I.R.S. Priv. Ltr. Rul. 201102047 (Jan 14, 2011); I.R.S. Priv. Ltr. Rul. 201042001 (Oct. 22, 2010); I.R.S. Priv. Ltr. Rul. 200946036 (Nov. 13, 2009).

⁸ Rev. Proc. 2016-50 (2016-43 I.R.B. 522).