

January 23, 2019

Treasury Issues Proposed Regulations Permitting RIC Pass-Through of Qualified REIT Dividends, Reserves on Qualified PTP Income

On January 18, 2019, the Treasury Department and IRS issued proposed regulations (the “Proposed Regulations”) that generally permit regulated investment companies (“RICs”) to pass through to their non-corporate shareholders qualified REIT dividends eligible for the 20% deduction under Section 199A of the Internal Revenue Code of 1986, as amended (the “Code”).¹ Taxpayers are entitled to rely on the portion of the Proposed Regulations permitting this “conduit treatment” for qualified REIT dividends immediately. The Proposed Regulations reserve on extending conduit treatment to qualified publicly traded partnership (“PTP”) income, citing as-yet-unaddressed complexities associated therewith, and solicit comments on whether and how future regulations could accommodate the extension of conduit treatment to qualified PTP income earned through RICs.

The legislation commonly known as the Tax Cuts and Jobs Act² added Section 199A to the Code in December 2017. Section 199A(b)(1) generally allows individuals and certain trusts and estates a deduction for up to 20% of the taxpayer’s combined “qualified REIT dividends” and “qualified PTP income.” The statutory language does not make clear whether RIC distributions attributable to such amounts from the RIC’s investment in a REIT or PTP qualify for the deductions available in respect of such amounts received directly from a REIT or PTP.

Conduit Treatment for Qualified REIT Dividends

The Proposed Regulations enact conduit treatment for qualified REIT dividends pursuant to the authority of Section 199A(f)(4), which directs the Secretary to adopt regulations necessary to carry out the purpose of Section 199A in the case of “tiered entities.” The preamble explains that conduit treatment is consistent with similar statutory provisions for interest-related, short-term capital gain, and exempt-interest dividends (among others), and with the broader purposes of the special tax treatment that Subchapter M accords RICs, which enables “small investors to gain benefits, such as professional management and broad diversification, that otherwise would be available only to investors with more resources.” According to the preamble, such treatment also furthers the goal of an economically efficient tax system, by correcting a “market distortion” that arises where qualified REIT dividends earned through RICs are taxed less favorably than such amounts received directly.

Prop. Reg. § 1.199A-3(d) thus treats any “section 199A dividend” as a qualified REIT dividend in the hands of a recipient shareholder, provided the shareholder meets equivalent requirements in respect of its RIC shares as those that apply to qualified REIT dividends received on REIT shares held directly – that is, the shareholder must hold the dividend-paying share for at least 46 days of the 91-day period beginning 45 days before the share becomes ex-dividend, and must not be under an obligation to make related payments with respect to a position in substantially similar or related property.³ Any RIC to which Section 852(b) applies is permitted to pay section 199A dividends.⁴

A “section 199A dividend” is any dividend or portion thereof that a RIC pays to its shareholders and reports as a section 199A dividend, to the extent derived from the aggregate amount of qualified REIT dividends includible in the RIC’s taxable income for the taxable year less expenses properly allocable thereto (“qualified REIT dividend income”).⁵ In

¹ Unless otherwise stated, all “Section” references herein are to the Code.

² Pub. L. No. 115-97.

³ Prop. Reg. § 1.199A-3(d)(4)(i)-(ii); Treas. Reg. § 1.199A-3(c)(2)(ii).

⁴ Prop. Reg. § 1.199A-3(d)(1).

⁵ Prop. Reg. § 1.199A-3(d)(2)(i); Prop. Reg. § 1.199A-3(d)(3)(v).

general, amounts reported as section 199A dividends in excess of qualified REIT dividend income must be prorated over all distributions for the taxable year.⁶

Comments on Qualified PTP Income Solicited

The Proposed Regulations do not extend conduit treatment to qualified PTP income. Although the recently published Bluebook⁷ indicates that conduit treatment is intended in the case of both qualified REIT dividends and qualified PTP income, the preamble explains that conduit treatment for qualified PTP income entails further complexities that must first be addressed, and in particular determining:

- How the “specified service trade or business” (“SSTB”) rules under Section 199A(d)(2) would apply to RIC shareholders with varying income levels, since SSTB income from the PTP could be qualified income with respect to some RIC shareholders but not for others with taxable income above the phase-out range;
- How loss carryforwards arising as a result of the rules prohibiting a PTP from netting losses from a SSTB against a non-SSTB would be reflected at the RIC shareholder level; and
- Whether and the extent to which non-U.S. shareholders and tax-exempt shareholders must treat qualified PTP income they receive through a RIC as ECI and UBTI, respectively.

The Treasury solicits comments addressing how these questions might be addressed, and in particular with regard to:

- Whether RICs have sufficient qualified items of PTP income to warrant conduit treatment;
- How to provide conduit treatment for shareholders with income below the SSTB threshold or within the phase-out range;
- How to treat losses of PTPs arising from SSTBs and non-SSTBs;
- Whether SSTB items are sufficiently rare or incidental for PTPs that a conduit regime should exclude all SSTB items;
- Whether conduit treatment for qualified PTP income can be disregarded for purposes of calculating ECI and UBTI at the shareholder level; and
- How to apply conduit treatment for qualified PTP income in a way that is consistent with the policy goal of preserving the overall simplicity of the tax treatment of investors in RICs while still achieving the policy goals of Section 199A and Section 199A(b)(1)(B) in particular.

If you have any questions about the Proposed Regulations, please contact a member of the [tax practice](#).

⁶ Prop. Reg. § 1.199A-3(d)(2)(ii); Prop. Reg. § 1.199A-3(d)(2)(iii)(A). In order to help RICs avoid the need to amend Forms 1099 and other shareholder reports, in the case of a non-calendar year-end RIC, any such excess reported amount is allocated solely to dividends paid after December 31. Prop. Reg. § 1.199A-3(d)(2)(iii)(B).

⁷ General Explanation of Public Law 115-97, JCS-1-18 (December 20, 2018).