IRS Provides Guidance on the Treatment of Excess Inclusion Income for Pass-Through Entities

The Internal Revenue Service (the "IRS") has released guidance in Notice 2006-97 and Revenue Ruling 2006-58 on the appropriate tax treatment of so-called "excess inclusion income" received by pass-through entities, including regulated investment companies ("RICs"). This guidance is potentially applicable to any RIC that receives income from the equity interests of certain mortgage pooling vehicles, either directly or, as is more likely, through an investment in a real estate investment trust ("REIT") holding such interests. The new guidance imposes significant reporting, withholding, and tax payment responsibilities on RICs with respect to excess inclusion income.

Background: Excess Inclusion Income and Taxable Mortgage Pools

The Internal Revenue Code of 1986, as amended (the "Code")[1] has long included special provisions addressing the tax treatment of "excess inclusion income" from the equity interests in real estate mortgage investment conduits ("REMICs") and REITs qualifying as taxable mortgage pools. REMICs are mortgage-pooling vehicles that meet certain requirements to qualify for pass-through taxation. In addition to their "regular" interests, which are treated as debt for federal income tax purposes, REMICs are required under the Code to issue a single "residual" interest, which is akin to equity. Pursuant to section 860E, residual interest holders must recognize in income on a current basis the greater of the REMIC's taxable income and a certain notional amount referred to as the "excess inclusion."[2] Under the Code, the same rule applies to the equity interest holders of a REIT or qualified REIT subsidiary that also meets the definition of a "taxable mortage pool." Taxable mortgage pools are mortgage-pooling vehicles that do not satisfy the REMIC requirements and are thus subjected to corporate-level taxation. Accordingly, the guidance in Notice 2006-97 applies to "excess inclusion income" from both REMIC residual interests and REITs that qualify as taxable mortgage pools.

Allocation of Excess Inclusion Income to RIC Shareholders

To ensure that the character of excess inclusion income flows properly through certain pass-through entities, section 860E(d) of the Code provides that, under regulations to be issued, a REIT must allocate to its shareholders the excess, if any, of its aggregate excess inclusions over its taxable income in accordance with dividends. The new interim guidance from the IRS makes clear that RICs must similarly allocate to their shareholders any excess inclusion income.

Generally speaking, a RIC must take the following steps to conform to this interim guidance. First, it must determine whether it has received any excess inclusion income for the tax year, and, if so, allocate it to its shareholders. Such income is most likely to arise from the RIC's investment in a REIT that holds REMIC residual interests or that qualifies as a taxable mortgage pool. In certain instances (see below), the RIC must report the amount and character of this excess inclusion income to shareholders. Second, the RIC must identify its shareholders that are "disqualified organiza-

[1] Unless otherwise specified, all section references herein are to sections of the Code.

[2] Excess inclusion income therefore consists of "phantom" (non-cash) income for tax purposes.

tions" (as defined below) and pay tax at the highest federal corporate tax rate on the excess inclusion income attributable to them. Finally, it must withhold tax at the full 30% on the excess inclusion income attributable to foreign shareholders. These requirements are discussed in more detail below.

Special Reporting Requirements for RICs

Under the new guidelines, RICs are subject to certain reporting obligations with respect to non-de minimis amounts of allocable excess inclusion income. First, they must inform shareholders who are nominees of the amount and character of the excess inclusion income allocated to them. With respect to shareholders who are not nominees, beginning on or after January 1, 2007, they must report excess inclusion income to shareholders in two cases:

- If the excess inclusion income received by a RIC from all sources exceeds 1% of the RIC's gross income, it must inform the non-nominee shareholders of the amount and character of excess inclusion income allocated to them.
- If a RIC received excess inclusion income from a REIT whose excess inclusion income in its most recent tax year ending not later than nine months before the first day of the RIC's taxable year exceeded **3%** of the REIT's total dividends, the RIC must inform its non-nominee shareholders of the amount and character of the excess inclusion income allocated to them from such REITs.

Compliance with these requirements will require RICs to obtain significant cooperation from the REITs in which they invest.

Charitable Remainder Trusts Do Not Incur UBTI by Receiving Excess Inclusion Income

The Code treats excess inclusion income - whether received directly or indirectly - as unrelated business taxable income ("UBTI") for those tax-exempt entities that are subject to the unrelated business income tax under section 511. Because charitable remainder trusts lose their tax-exempt status entirely if they incur any UBTI whatsoever, in the absence of clarity many charitable remainder trusts avoided investing (either directly or indirectly through a RIC) in a REIT that received excess inclusion income. Revenue Ruling 2006-58 clarifies that excess inclusion income is not UBTI in the hands of a charitable remainder trust (since they cannot be subject to the unrelated business income tax). This means that a charitable remainder trust need no longer avoid RICs that invest in REITs out of concern for its tax exemption.

Tax on RICs' Excess Inclusion Income Attributable to Charitable Remainder Trusts and Other Disqualified Organizations

In order to prevent charitable remainder trusts and certain other tax-exempt entities from avoiding the tax on excess inclusion income, Section 860E(e)(6) imposes a tax on pass-through entities (including RICs) at the highest corporate tax rate on their excess inclusion income attributable to "disqualified organizations." Disqualified organizations include: (1) certain federal, state, and foreign governmental entities; (2) tax-exempt organizations (such as charitable remainder trusts) not subject to the unrelated business income tax, other than farmers' cooperatives; and (3) certain rural electrical and telephone cooperatives. Thus, under the new IRS guidance, RICs must identify shareholders that are "disqualified organizations" and pay tax on the excess inclusion income attributable to them. This requirement may pose significant compliance difficulties for RICs.

To the extent permissible under the Investment Company Act of 1940, as amended, RICs are permitted under the Treasury Regulations promulgated under Code section 860E to specially allocate this tax expense to the disqualified organizations to which it is attributable, without a concern that such an allocation will constitute a preferential dividend.

Withholding on Excess Inclusion Income Allocable to Foreign Investors

Lastly, because the Code provides that excess inclusion income is ineligible for treaty benefits, RICs must now withhold tax on excess inclusions attributable to their foreign shareholders at the full 30% rate of withholding, regardless of any treaty benefits for which a shareholder is otherwise eligible. This requirement may prove problematic for RICs both because it requires them to impose different withholding rates on REIT dividends (for instance) depending on the type of income at issue, and because the liability for withholding is uncertain, since RICs will, by necessity, rely largely on preliminary calendar-year figures voluntarily provided by REITs for purposes of excise tax-related distributions.

We are currently developing appropriate disclosure language to be included in the Statements of Additional Information of RICs that may be affected by the new IRS guidance. We are also considering drafting formal comments to submit to the IRS in response to this initial guidance.

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