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New Proposed RIC Regulations

It is a good thing to qualify as a Regulated Investment Company (a "RIC"). All domestic corporations are subject to income tax on their net taxable income. Regular domestic corporations ("subchapter C corporations") are taxed on their income before they distribute dividends to owners. They may not deduct dividends from taxable income. As a result, every dollar earned by a subchapter C corporation is taxed twice, i.e. once at the corporate level, and once at the shareholder level. For example, if ABC Corporation has $100 of net taxable income in 2016, it will pay $35 ($100 x the marginal corporate tax rate of 35 percent) to the government. This will leave it with $65, in cash. If this is distributed to shareholders in the form of a dividend, the cash will be subject to tax once more as income to the shareholder. Assuming that dividends are "qualified dividends," taxable at a rate of 20 percent, this will leave the shareholder with $52, in cash, once the shareholder has paid $13 to the IRS.

By contrast, RICs may deduct dividends from taxable income. If a RIC were to earn $100 in net income in 2016 and distribute all of its cash as a dividend, it would have $0 taxable income for the year. The dividend would be taxable to the shareholder as ordinary income. Assuming the dividend would be taxed at the top ordinary income rate of 39.6 percent, this would leave the taxpayer with $60.40 in cash, after taxes. The benefit of RIC status is illustrated in Table 1:

Table 1

	C Corp	RIC
Net Income	$ 100.00	$ 100.00
Dividends Paid Deduction	$ -	$ (100.00)
Taxable Corporate Income	$ 100.00	$ -
Corporate Tax Rate	35%	35%
Corporate Tax Paid	$ (35.00)	$ -
Cash to be Distributed	$ 65.00	$ 100.00
Dividend Income	$ 65.00	$ 100.00
Individual Tax Rate	20%	39.60%
Individual Tax Paid	$ (13.00)	$ (39.60)
Cash Remaining	$ 52.00	$ 60.40

On Sept. 28, the Treasury Department issued proposed regulations and a Revenue Procedure that make it slightly harder for certain entities to qualify as RICs.

To qualify as a RIC, a corporation must satisfy several requirements, including the following:

- Registration as an investment company. It must be registered under the Investment Company Act of 1940 (the "Investment Company Act"), or have made an election thereunder to be treated as a business development company; and
- Annual distributions. It must meet certain minimum distribution requirements each year so that taxable income reaches the hands of the taxpaying owners.
- Income requirement. At least 90 percent of its gross income must be derived from the business of investing in stock, securities or currencies. This may include dividends, interest, income from securities loans, gain from the sale or disposition of stock or securities, or foreign currencies, or other income (including, but not limited to gain from certain derivatives) derived with respect to the business of investing in stock, securities or commodities (the "income test"); and,
- Asset requirements. At least 50 percent of its total assets must be represented by cash, cash items, government securities and securities of other RICs, and other securities, provided that certain diversification requirements are met with respect thereto (the "asset test").

Definitions in the Investment Company Act control both the income test and the asset test. The Internal Revenue Code (the "Code") specifies that "gain from the sale or disposition of stock or securities" is limited to gain from the sale or disposition of instruments treated as stock or securities under section 2(a)(36) of the Investment Company Act, and it also states that, unless otherwise specified, definitions in the Investment Company Act apply to the asset test.

The newly-issued guidance provides clarification regarding the treatment of two financial statement items under the income test and the asset test:

- First, the preamble to the proposed regulations and the Revenue Procedure clarify that the SEC has exclusive jurisdiction in determining whether an instrument constitutes a "security" for purposes of the Investment Company Act. Prior to 2011, the IRS had issued both public and private guidance on this topic

on multiple occasions. This was most relevant to the distinction between a "security" and a "commodity" for purposes of the income and asset tests. For example, the IRS ruled in 2006 that a derivative contract that referenced a commodity index is not a "security" for these purposes, but it stated in subsequent private guidance that shares in a corporation that owned a portfolio of commodity positions was a "security" for these purposes, even though it provided economic exposure similar to a derivative or cash position in commodities. In 2011, the IRS stated that it would no longer issue private guidance on this topic; in the new proposed regulations, the IRS washes its hands of the issue entirely by acknowledging that the SEC's jurisdiction in this area is exclusive.

The foregoing rule is effective as of Sept. 27, 2016.

> Second, the proposed regulations specify that taxable income from a so-called "951(a) inclusion," or a "1293 (a) inclusion" may constitute qualifying income for purposes of the income test only if the inclusion is accompanied by an actual cash distribution. Generally, Section 951(a) of the Code requires a United States shareholder of a controlled foreign corporation (a "CFC") to include in taxable income the shareholder's pro rata share of the CFC's "subpart F income" for the tax year regardless of whether the CFC actually distributes cash to the shareholder. Subpart F income includes, *inter alia*, passive income from investing in stocks, securities and currencies. Similarly, Code Section 1293(a) requires a U.S. resident that holds shares in an a "qualified electing fund" (i.e., a passive foreign investment company that has filed a qualified electing fund election) to include its pro rata share of the qualified electing fund's ordinary income and net capital gain in taxable income currently. The Code specifies that 951(a) and 1293(a) inclusions may constitute dividends for purposes of the income test only to the extent that there is an actual distribution of cash by the CFC that accompanies the inclusion. Despite this, the IRS has, on occasion, issued private guidance to the effect that cashless 951(a) or 1293(a) inclusions may constitute, if not dividends, then other income that also qualifies for purposes of the income test as income "derived with respect to [a RIC's] business of investing in . . . stock, securities or currencies." The proposed regulations indicate that the IRS has reversed course and now takes the position that cashless 951(a) and 1293(a) inclusions may never constitute income that qualifies under the income tests as *either* dividends or income derived with respect to a business of investing in stock for purposes of the income test, and will no longer issue guidance on this point.

The proposed regulations will be effective for tax years beginning on or after the date that is 90 days after the publication of final regulations in the Federal Register.

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