INVESTMENT COMPANY INSTITUTE

MEMO# 32661

August 6, 2020

Proposed Regulations Permitting RICs to Pay Section 163(j) Interest Dividends

[32661]

August 6, 2020 TO: ICI Members
Tax Committee SUBJECTS: Tax RE: Proposed Regulations Permitting RICs to Pay Section 163(j) Interest Dividends

The Treasury Department and the Internal Revenue Service (IRS) have released proposed regulations that would permit regulated investment companies (RICs) to pass through interest income to corporate shareholders for purposes of determining such corporations' interest expense limitation under section 163(j), as requested by ICI.[1] These proposed regulations would provide a RIC's corporate shareholders with interest income rather than ordinary dividend income, potentially increasing the amount of interest expense the shareholders can deduct under the new limits implemented by the 2017 tax legislation commonly referred to as the "Tax Cuts and Jobs Act."

Section 163(j) Interest Dividends

A section 163(j) interest dividend is defined in the proposed regulations as any dividend, or part of a dividend, that is reported by the RIC as a section 163(j) interest dividend in written statements provided to its shareholders.[2] The proposed regulations would limit the amount of section 163(j) interest dividends that a RIC may report to the excess of the RIC's business interest income for the taxable year over the total of the RIC's business interest expense for the taxable year and other deductions that are properly allocable to the RIC's business interest income. These rules are based on the existing rules for reporting tax-exempt interest under section 852(b)(5) and interest related dividends in section 871(k)(1).

Specifically, the proposed regulations provide that if the "aggregate reported amount"[3] for the taxable year exceeds the "excess section 163(j) interest income"[4] of the RIC for the taxable year, then the section 163(j) interest dividend is the reported section 163(j) interest dividend amount reduced by the "excess reported amount"[5] that is allocable to that reported section 163(j) interest dividend amount.[6]

The excess reported amount, if any, that would be allocable to the reported section 163(j) interest dividend amount is that portion of the excess reported amount that bears the same ratio to the excess reported amount as the reported section 163(j) interest dividend amount bears to the aggregate reported amount.[7] For non-calendar year RICs, the aggregate reported amount is determined by including only those dividends paid after December 31 of the taxable year, and no excess reported amount is allocated to any dividend paid on or before December 31 of such taxable year.[8]

General Rule for Shareholders

The proposed regulations provide that a section 163(j) interest dividend would be treated as interest income for purposes of section 163(j).[9] There is a cap, however, on the “conduit amounts” that a shareholder can take into account, despite guidance permitting a RIC to report the maximum amount of certain distributions even if the sum of those reported amounts exceeds the RIC’s dividends for the taxable year.[10] Under the proposed regulations, a shareholder could not treat any part of a section 163(j) interest dividend as interest income to the extent the amount of the section 163(j) interest dividend exceeds the excess of the entire dividend over the sum of the conduit amounts (other than interest-related dividends under section 871(k)(1)(c) and section 163(j)).[11]

“Conduit amounts” are the amounts designated by a RIC for that taxable year that are subject to a limit determined by reference to that category of income. For example, a RIC’s conduit amount with respect to its net capital gain is the amount of capital gain dividends that the RIC pays under section 852(b)(3)(C).[12]

Holding Period Requirements

Under the proposed regulations, a dividend from a RIC would be treated as interest income under section 163(j) only if the shareholder held the RIC stock for more than 180 days during the 361-day period beginning on the date that is 180 days before the ex-dividend date, or provided that the shareholder is not under an obligation to make related payments with respect to positions in substantially similar or related property pursuant to a short sale or other transaction.

The holding period requirements would not apply to dividends paid by a RIC regulated as a money market fund under Rule 2a-7 of the Investment Company Act of 1940. It also would not apply to regular dividends paid by a RIC that declares section 163(j) interest dividends daily in an amount equal to at least 90 percent of its excess section 163(j) interest income and distributes such dividends on a monthly or more frequent basis.

Effective Date

The proposed regulations would apply to taxable years beginning on or after the date that is 60 days after final regulations are published in the Federal Register. Taxpayers may choose to apply the rules in the proposed regulations, however, for taxable years beginning after December 31, 2017, and before the effective date of the final regulations, so long as the taxpayers and their related parties apply the rules consistently.

Comments Requested

The Treasury Department and the IRS have requested comments on the proposed regulations within 60 days of the publication of the proposed regulations in the Federal Register (on or about September 28, 2020). Therefore, please provide any comments to me (kgibian@ici.org) no later than **Tuesday, September 8, 2020**.

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endnotes

[1] *See* Institute Memorandum No. 31841, dated July 9, 2019, which can be found at: https://www.ici.org/my_ici/memorandum/memo31841.

[2] Prop. Reg. § 1.163(j)-1(b)(35)(i).

[3] "Aggregate reported amount" means the amount of dividends reported by the RIC as section 163(j) interest dividends for the taxable year (including section 163(j) interest dividends paid in a spillover distribution). Prop. Reg § 1.163(j)-1(b)(35)(iv)(B).

[4] "Excess section 163(j) interest income" means, with respect to a taxable year of a RIC, the excess of the RIC's business interest income for the taxable year over the sum of the RIC's business interest expense for the taxable year and the RIC's other deductions for the taxable year that are properly allocable to the RIC's business interest income. Prop. Reg. § 1.163(j)-1(b)(35)(iv)(E).

[5] The "excess reported amount" is the excess of the aggregate reported amount over the RIC's excess section 163(j) interest income for the taxable year. Prop. Reg. § 1.163(j)-1(b)(35)(iv)(B).

[6] Prop. Reg. § 1.163(j)-1(b)(35)(ii).

[7] Prop. Reg. § 1.163(j)-1(b)(35)(iii)(A).

[8] Prop. Reg. § 1.163(j)-1(b)(35)(iii)(B).

[9] Prop. Reg. § 1.163(j)-1(b)(22)(iii)(F)(1).

[10] *See* Rev. Rul. 2005-31.

[11] Prop. Reg. § 1.163(j)-1(b)(22)(iii)(F)(2).

[12] Prop. Reg. § 1.163(j)-1(b)(22)(iii)(F)(3).