MEMO# 30991

December 21, 2017

Tax Legislation Passed by Congress

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December 21, 2017 TO: ICI Members
Pension Committee
Pension Operations Advisory Committee
Tax Committee SUBJECTS: Pension
Tax RE: Tax Legislation Passed by Congress

The House of Representatives and the Senate have passed H.R. 1, the tax bill (the "Act"), and President Trump is expected to sign the final legislation before the end of the year or shortly thereafter. The Institute is extremely pleased to report that the conference committee charged with reconciling differences between the House and Senate bills resolved additional Institute priority issues in a favorable fashion. As summarized below, the new law preserves retirement-savings tax incentives, maintains the tax exemption of interest for public purpose state and local bonds and private activity bonds, and does not require investors to utilize the first-in, first-out (FIFO) method to determine which lots of a specific security have been sold.

The Act includes a few relatively minor changes to the retirement savings provisions of the Code, which are described below. There also are some outstanding technical issues in the Act, as discussed below, that impact regulated investment companies ("RICs") and their shareholders. The Institute will continue working with legislative staff and the Treasury Department and Internal Revenue Service to address these concerns.

I. Institute Priorities

Tax Treatment of Retirement Savings

Consistent with Institute efforts to maintain the current tax incentive framework for retirement savings, the Act does not include any mandatory Roth treatment of retirement savings contributions. In light of the revenue-raising potential of such "Rothification" proposals, the rejection of those proposals and continuation of the current tax incentives reflects policymakers' understanding and appreciation of the retirement system's success. In addition, a number of earlier-included provisions which would have limited retirement savings (e.g., elimination of catch-up contributions for high-earners and conforming 403(b) and 457 plan contribution limits with those of 401(k) plans) were dropped from the legislation.

Municipal Bonds

The Institute's continued advocacy to preserve the tax exemption for municipal bonds was successful, as the Act generally preserves current law for most municipal bonds. Significantly, public purpose state and local government bonds remain exempt from tax. The Act also dropped a House provision that would have repealed the tax exemption for interest on qualified private activity bonds. Thus, qualified private activity bonds continue to be fully tax exempt. The Act does, however, eliminate the tax exemption for advance refunding bonds issued after December 31, 2017.

Financial Transactions

Neither the Senate nor the House bill included proposals to require mark-to-market taxation for derivatives. The Senate bill did include a mandatory FIFO provision, though RIC portfolio transactions were excluded and RIC shareholders would have been permitted to continue using average cost. This rule would have applied to both debt and equity sold or otherwise disposed of after December 31, 2017. The FIFO provision was dropped in its entirety from the final bill passed by Congress. Given the deleterious impact of mandatory FIFO on investors, we are pleased with this outcome.

II. Retirement Savings Provisions

Prohibition on recharacterization of IRA conversions

Section 13611 of the Act eliminates the ability under Code section 408A(d)(6) to recharacterize or unwind a conversion to a Roth IRA, effective for taxable years beginning after December 31, 2017. Taxpayers will continue to be able to recharacterize contributions to one type of IRA (traditional or Roth) as a contribution to the other type of IRA before the individual's income tax return due date (including extensions). **For Roth conversions occurring in 2017, taxpayers will have until the tax return deadline with extensions (i.e., October 15, 2018) to unwind the conversion, according to informal guidance from the Treasury Department and the IRS.**

Extended period for rollover of plan loan offset amounts

Section 13613 of the Act extends the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution, from 60 days after the date of the offset to the due date (including extensions) for filing the individual's income tax return for the taxable year in which the plan loan offset occurs (i.e., the taxable year in which the amount is treated as distributed from the plan). The extended period is available for plan loan offset amounts that are treated as distributed from a qualified retirement plan, a section 403(b) plan, or a governmental section 457(b) plan, solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's severance from employment. The provision is effective for plan loan offset amounts treated as distributed in taxable years beginning after December 31, 2017.

Relief for qualified 2016 disaster distributions

Section 11028 of the Act provides limited tax relief relating to certain 2016 disaster areas, specifically those areas with respect to which a major disaster was declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency

Assistance Act during calendar year 2016. With respect to retirement savings, the provision provides an exception to the 10-percent early withdrawal tax in the case of a "qualified 2016 disaster distribution" from a qualified retirement plan, a section 403(b) plan, or an IRA. The provision is effective on the date of enactment.[1]

A "qualified 2016 disaster distribution" is a distribution from an eligible retirement plan made on or after January 1, 2016, and before January 1, 2018, to an individual whose principal place of abode at any time during calendar year 2016 was located in a 2016 disaster area and who has sustained an economic loss by reason of the events giving rise to the Presidential disaster declaration. The total amount of distributions to an individual from all eligible retirement plans that may be treated as qualified 2016 disaster distributions is $100,000.

In addition, under the Act, income attributable to a qualified 2016 disaster distribution may be included in income ratably over three years, and the amount of a qualified 2016 disaster distribution may be recontributed to an eligible retirement plan within three years. Amounts recontributed within the three-year period are treated as rollovers and individuals may file amended returns to claim refunds of the tax attributable to amounts previously included in income.

The Act provides that plan amendments made pursuant to the provision (or a regulation issued thereunder) may be retroactively effective if the amendment is made on or before the last day of the first plan year beginning after December 31, 2018 (or in the case of a governmental plan, December 31, 2020), or a later date prescribed by Treasury, as long as the amendment applies retroactively for the period and the plan operates in accordance with the amendment during that period.

III. 529 and ABLE Account Provisions

Expansion of 529 plans to cover elementary and secondary education expenses

Section 11032 of the Act permits limited distributions from 529 plan accounts to cover tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private or religious elementary or secondary school. Distributions are limited to not more than $10,000 on a per-student basis, rather than a per-account basis. The provision applies to distributions made after December 31, 2017.

Rollovers between 529 plan accounts and ABLE accounts (temporary)

Section 11025 of the Act permits amounts from 529 plan accounts to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 plan account, or a member of such designated beneficiary's family. Such rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a taxable year. The provision applies to distributions after the date of enactment, but does not apply for distributions after December 31, 2025.

Temporary increase of contributions to ABLE accounts and application of saver's credit

Section 11024 of the Act temporarily increases the contribution limit for ABLE accounts, but only with respect to contributions made by the designated beneficiary of the ABLE account. Under the temporary provision, after the overall limitation on ABLE account contributions (the annual gift tax exclusion, or $14,000 for 2017) is reached, an ABLE account's designated beneficiary may contribute an additional amount, up to the lesser of (a) the Federal poverty line for a one-person household; or (b) the individual's compensation for the taxable year. In addition, the provision temporarily allows a designated beneficiary of an ABLE account to claim the saver's credit under Code section 25B for contributions made to his or her ABLE account. The provision is effective for taxable years beginning after the date of enactment, but does not apply to taxable years after December 31, 2025.

IV. Outstanding Tax Issues

Several provisions in the Act impacting RICs and their shareholders need to be clarified or modified through regulatory guidance or legislative action. These include:

Pass-through of special rates for REITs and MLPs

Section 11011 of the Act permits taxpayers a 20% deduction for "qualified business income" from certain pass-through entities, such as partnerships, S corporations, and limited liability companies. Qualified business income, as defined in new section 199A, includes certain dividends from real estate investment trusts ("REITs"), cooperatives, and publicly traded partnerships, including oil and gas master limited partnerships ("MLPs").

The Act does not, however, provide a mechanism for RICs that invest in REITs and MLPs to pass through the character of the dividends it receives from those REITs and MLPs. Thus, under the Act, an investor who invests in a REIT or MLP directly would be eligible for the 20% deduction for qualified business income. An investor in a REIT fund or MLP fund, however, would not be permitted to take the deduction for income from the REITs or MLPs.

Inclusion of income not later than for financial accounting purposes

Section 13221 of the bill amends section 451 to require taxpayers to include certain amounts in income no later than such amounts are included in revenue on financial statements. The scope of this provision is unclear. Contrary to a widely circulated analysis, however, the conference report specifically notes that the amendment does not affect the timing of unrealized gains and losses.[2]

It is unclear whether the provision applies to the market discount rules. Under Generally Accepted Accounting Principles (GAAP), market discount is accrued currently on a constant yield to maturity basis. Under the tax code, taxpayers do not recognize market discount as income until disposition of the bond, although taxpayers may elect to accrue it currently. Most mutual funds elect to accrue market discount currently; however, most municipal bond funds do not. If this provision applies to market discount, it could require municipal bond funds to recognize taxable ordinary income currently to the extent of any market discount. Clarification also is needed regarding the effective date for certain debt instruments and when section 481 adjustments are required.

Limitation on deduction of net interest expense

Section 13301 of the Act amends section 163(j) to provide new limitations on the business interest deduction. In general, the new rules limit the deduction for net business interest expense to 30% of the taxpayer's adjusted taxable income. The deduction for interest expense is not limited to the extent of any business interest income, which is interest income attributable to a trade or business and not investment income. It is unclear whether RICs should be treated as having investment income under this provision, or whether they *de facto* are engaged in a trade or business because they are corporations under the tax code. Because this provision could have ramifications for leveraged closed-end funds that invest in equities and business development corporations, clarification is needed.

Transitional repatriation of deferred foreign income

Section 14103 of the Act provides rules intended to help taxpayers transition from our current worldwide system of taxation to a participation exemption system. These rules generally require a US shareholder (including a RIC) that owns 10% or more of a foreign corporation to include as current income its pro rata share of the foreign corporation's post-1986 undistributed accumulated earnings and profits for its last taxable year beginning before January 1, 2018. If a RIC is a 10% shareholder, it is unclear how that undistributed income would be treated under the RIC qualification tests under subchapter M. The Act already provides special rules for REITs. Pursuant to these rules, such income is not taken into account for purposes of the REIT gross income test, and REITs may elect to distribute such income to their shareholders over an 8-year period. Similar rules should be provided for RICs.

Downward attribution for controlled foreign corporations

Section 14214 of the Act deletes section 958(b)(4) of the Code, which prevents downward attribution of stock ownership when a US corporation owns shares of a foreign corporation that owns shares of a second foreign corporation for determining whether the US corporation owns shares in a controlled foreign corporation (CFC). When a US corporation is a shareholder in a CFC, the Subpart F rules require current inclusion by the US corporation of certain undistributed income of the CFC. This change in law could cause a RIC or other US taxpayer that owns more than 10% of a foreign corporation that is not a CFC to inadvertently become a US shareholder in a CFC.

Withholding on transfers of partnership interests

Section 13501 of the Act makes the sale of a partnership interest by a foreign partner "effectively connected income" (ECI). It also requires a transferee of a partnership interest to withhold 10% of the sale proceeds unless the transferor certifies that the transferor is not a foreign person. The Act provides the Treasury Department regulatory authority to provide that a broker, rather than the transferee, may serve as the withholding agent upon the sale. Regulations to this effect are necessary to ensure that RICs are not required to assume the withholding duties when they purchase MLP or other partnership interests.

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Rep. Brady, chair of the House Committee on Ways and Means, has indicated that the Congress will work on technical corrections to the Act in 2018. The Treasury Department and the IRS also may provide regulatory guidance to the extent that they have the authority to do so. The Institute will continue to work with both to try to resolve these issues.

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endnotes

[1] The provision also includes modifications to the rules for casualty losses relating to 2016 disaster areas.

[2] *See* H.R. REP. No 115-466, at 428, n. 872 (2017) (Conf. Rep.).