

COMMENT LETTER

September 27, 2018

ICI Letter on Pass-Through of Qualified REIT Dividends and PTP Income Under Section 199A (pdf)

By Electronic Delivery September 27, 2018 Tom West William Paul Tax Legislative Counsel Acting Chief Counsel U.S. Department of the Treasury Internal Revenue Service 1500 Pennsylvania Avenue, NW 1111 Constitution Avenue, NW Washington, DC 20220 Washington, DC 20224 RE: Proposed Regulations on Section 199A (REG-107892-18) Dear Mr. West and Mr. Paul: The Investment Company Institute¹ asks the Treasury Department and the Internal Revenue Service (IRS) to clarify that regulated investment companies (RICs) can pass through to RIC shareholders certain qualified dividends from real estate investment trusts (REITs) and income from publicly traded partnerships (PTPs) so that RIC shareholders can take the 20 percent deduction under section 199A.² The recently proposed regulations under section 199A do not specifically address this issue. We believe that sections 7805(a) and 199A(f)(4) provide the Treasury Department and the IRS with authority to clarify that RICs can pass this special income through to the RIC shareholders.³ Section 199A, as enacted by Pub. L. No. 115-77 (commonly referred to as the Tax Cuts and Jobs Act of 2017, or the TCJA), gives taxpayers a 20 percent deduction for “qualified business income.” It also provides a 20 percent deduction for “qualified REIT dividends” and “qualified publicly traded partnership income.” The TCJA does not specifically provide a

¹ The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s members manage total assets of US\$22.4 trillion in the United States, serving more than 100 million US shareholders, and US\$7.3 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

² Unless otherwise noted, references to “section” in this letter refer to sections of the Internal Revenue Code of 1986, as amended (the Code).

³ ICI anticipates that Nareit, the trade association for the REIT industry, will be submitting a similar recommendation regarding REIT shareholders through mutual funds, and ICI supports those comments. Nareit also asked for clarification on this issue in its letter to the IRS on the 2018-2019 Priority Guidance Plan. See Nareit letter dated June 14, 2018, which can be found at: <https://www.reit.com/sites/default/files/Nareit-PGP-Recommendations-2018-19-Final.pdf>.

mechanism for RICs that invest in REITs or PTPs to pass through this qualified income. It thus is not clear whether RICs may do so absent additional guidance. Nareit estimates that

approximately 40 percent of all listed REIT shares are held through RICs.⁴ This includes REIT-specific open-end funds and exchange-traded funds (ETFs), which aim to provide diversified access to the real estate markets. It also includes open-end funds and ETFs that track equity indexes, as many REITs are included in indexes such as the S&P 500.⁵ According to Nareit data, approximately 15 million taxable US taxpayers hold REITs through RICs. Many of these taxpayers are middle-income Americans.⁶ Absent clarification under section 199A, these taxpayers may be penalized for choosing to hold REIT shares and interests in PTPs indirectly rather than directly. We believe that the Congress intended to permit RICs to pass through the character of qualified REIT dividends and qualified publicly traded partnership income so that RIC shareholders can take advantage of the deduction under section 199A. We can think of no good policy argument for differentiating between direct and indirect shareholders. In general, the tax law strives to provide RIC shareholders with tax treatment comparable to the treatment that would result if they held the RIC assets directly. In fact, the statute itself defines a qualified REIT dividend as any dividend from a REIT received by a taxpayer during the taxable year that is not a capital gain dividend or qualified dividend income.⁷ The statute does not specify that the qualified REIT dividend must be received directly from the REIT itself. RICs already pass through to shareholders capital gain dividends and qualified dividend income from REITs; it therefore is logical that they also would pass through this new third component under section 199A. We note that a RIC's ability to pass through different categories of capital gains from its REIT investments is not specifically set forth in Subchapter M of the Internal Revenue Code. Rather, RICs and REITs rely upon regulatory guidance to permit RIC shareholders to take advantage of the special capital gains rates applicable to REIT dividends.⁸ Nareit, based on data compiled by Citi Research, SNL, Bloomberg, FactSet, and Lipper. ⁵ See <https://www.reit.com/data-research/reit-indexes/reits-sp-indexes>. ⁶ See Investment Company Institute 2018 Fact Book, p. 147, Figure 7.6, which can be found at: <http://www.icifactbook.org>. ⁷ Sec. 199A(e)(3). ⁸ The Taxpayer Relief Act of 1997 provided new tax rates for capital gains in Section 1(h). Section 1(h), however, did not specifically describe the mechanism for RICs to pass through these categories of capital gains received from REITs to RIC shareholders. Like Section 199A, Section 1(h) contained a grant of regulatory authority, which the Treasury Department and IRS exercised by issuing Notice 97-64, which effectively permits RICs to pass through to shareholders the characterization of any REIT dividends among the three rates. The notice subsequently has been updated to reflect changes to section 1(h) while still permitting RICs to pass through various types of capital gains. When the qualified dividend income provisions were added in 2003, Notice 2004-39 provided that RICs could continue to apply the guidance in Notice 97-64 to this new category of income received from REITs. Following The Treasury Department and the IRS have regulatory authority to issue guidance clarifying the application of section 199A to RIC shareholders. In addition to the general regulatory authority provided under section 7805(a), section 199A(f)(4) provides that the Secretary "shall prescribe such regulations as are necessary to carry out the purposes of this section..." We believe that expressly permitting RICs to pass through qualified REIT dividends and qualified publicly traded partnership income would do just that, by permitting taxpayers to take the deduction provided under section 199A. Section 199A(f)(4)(B) also specifically provides that the Secretary may provide regulations for the application of this section in the case of "tiered entities." We note that the Treasury Department and the IRS have treated RICs and REITs as tiered entities in other instances.⁹ We believe, however, that the government can rely upon the more general grant of authority in section 199A(f)(4) to permit RICs to pass through qualified REIT dividends and qualified publicly traded partnership income. Given the intent of the statute and the regulatory authority provided, we thus ask the Treasury Department and the IRS to clarify that RICs may pass through to shareholders any qualified

REIT dividends and qualified publicly traded partnership income received by the RICs, thus allowing those taxpayers to take advantage of the deduction under section 199A. ICI and its members appreciate your consideration of our request. Please do not hesitate to contact me (202-371-5432 or kgibian@ici.org) if you have any questions or would like to discuss it further. Sincerely, /s/ Karen L. Gibian Karen Lau Gibian Associate General Counsel, Tax Law
cc: Krishna Vallabhaneni Michael Novey Holly Porter Helen Hubbard enactment of the RIC Modernization Act of 2010, the IRS and Treasury Department updated Notice 97-64 by issuing Notice 2015-41. Notice 2015-41 noted that the principles of Notice 97-64 would continue to apply. 9 See, e.g., Treas. Reg. § 1.362-3(d)(5) (subsection (iii) provides a look-through rule for “tiered entities” as described in subsection (d)(5)(1)(A), which includes in the definition RICs and REITs); Treas. Reg. § 1.7704-1(a)(2)(iii) (provides an exception for “tiered entities,” which includes RICs and REITs) .

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.