

Final Regulations Issued with Revisions to Examples that Illustrate the Controlled Group Rules Applicable to RICs

The Internal Revenue Service (IRS) recently promulgated final regulations¹ which contain amendments relating to the application of the controlled group rules under section 851(c) to regulated investment companies (RICs).

To qualify as a RIC, a taxpayer must meet asset diversification tests pursuant to which, at the close of each quarter of the RIC's taxable year, not more than 25 percent of the value of the taxpayer's total assets may be invested in (i) the securities (other than Government securities or the securities of other RICs) of any one issuer; (ii) the securities (other than the securities of other RICs) of two or more issuers that the taxpayer controls and that are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses; or (iii) the securities of one or more qualified publicly traded partnerships (as defined in section 851(h)) (the 25 percent tests).²

Section 851(c) provides special rules applicable to the asset diversification requirements of section 851(b)(3), including the 25 percent tests. The controlled group rules in section 851(c)(1) provide that, when ascertaining the value of a taxpayer's investment in the securities of an issuer for purposes of determining whether the 25 percent tests have been met, the taxpayer's proper proportion of any investment in the securities of such issuer that are held by a member of the taxpayer's "controlled group" must be aggregated with the taxpayer's investment in such issuer, as determined under regulations.

Section 851(c)(3) defines a controlled group as one or more chains of corporations connected through stock ownership with the taxpayer if (i) 20 percent or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and (ii) the taxpayer owns directly at least 20 percent or more of the total combined voting power of all classes of stock entitled to vote of at least one of the other corporations.

On August 2, 2013, the IRS promulgated proposed regulations (REG-114122-12) which revised certain examples in section 1.851-5 to clarify that a RIC and its controlled subsidiary are a controlled group even if the group consists of only that RIC and its subsidiary.

No public hearing was requested or held and written comments responding to the proposed regulations were received. After consideration of all the comments, these final regulations adopt the provisions of the proposed regulations with certain clarifications.

Comments received in response to the proposed regulations' request for comments addressed three general categories of issues: (1) application of the proposed changes to a parent RIC investing in the stock

¹ T.D. 9737

² See section 851(b)(3)(B).

of subsidiary RICs (a Fund of Funds structure); (2) application of the proposed changes to a RIC's indirect investment in qualified publicly traded partnerships, as defined in section 851(h) (QPTPs); and (3) clarification of existing regulatory language implementing the controlled group rules of section 851(c).

- (1) **Fund of Funds Structure.** In response to these requests, the IRS issued Revenue Procedure 2015-45³ which is described in the Tax Alert below.
- (2) **QPTP.** The IRS believes, consistent with the statutory language, that the controlled group rules should apply to section 851(b)(3)(B)(iii). A RIC is no longer able to circumvent the 25 percent limitation on QPTPs (including many natural resource Master Limited Partnerships 'MLPs') by investing both directly in QPTPs and indirectly in those same or other QPTPs through a wholly-owned domestic blocker corporation.
- (3) **Clarifying regulatory language.** As stated in the preamble to the proposed regulations, the IRS believes that the language in the examples in the existing regulations was intended merely to simplify the description of certain fact patterns and not to articulate a legal interpretation that is inconsistent with the statutory language of section 851(c) and the construction of substantially similar language elsewhere in the Code. The IRS believes that the revised examples are intended to, and do, make sufficiently clear how the statutory rules are to be interpreted and applied, and accordingly no changes are being made in response to this comment.

The final regulations apply to quarters that begin on or after December 14, 2015. Under section 851(d)(1), whether a taxpayer loses status as a RIC in one quarter may depend on whether the taxpayer satisfied section 851(b)(3) and (c) at the close of one or more prior quarters. For purposes of applying the first sentence of section 851(d)(1) to a quarter that begins on or after March 14, 2016, these final regulations apply in determining whether the taxpayer met the requirements of section 851(b)(3) and (c) at the close of prior quarters.

IRS Issues Rev. Proc. 2015-45: Criteria for a Regulated Investment Company in satisfying quarterly asset diversification requirements for a Fund of Funds structure, for which a Regulated Investment Company is deemed to be a controlling entity.

The IRS issued Revenue Procedure 2015-45, which describes conditions under which the IRS will treat an Upper RIC that invests in one or more Lower RICs as satisfying the 25 percent tests and provides procedures to lessen the burden of demonstrating compliance with the 25 percent tests, applying the market value exception and the 30-day cure provision, and dealing with different quarter-end testing dates. An Upper RIC is an entity that invests in other RICs as part of a fund of funds structure.

This revenue procedure applies to an Upper RIC that directly holds 20 percent or more of the total combined voting power of all classes of stock entitled to vote of one or more Lower RICs.

This revenue procedure does not apply to any Upper RIC if a purpose of the Fund of Funds structure is to enable the Upper RIC to invest (directly or indirectly through one or more members of the Upper RIC's controlled group) in securities of an issuer or category of issuers at levels that would not be permissible if the 25 percent tests were applied without regard to this revenue procedure. In such a case, the regular controlled group look-through rules (as illustrated by the new Treasury regulations) will apply to the Upper RIC when determining its quarterly compliance with the 25 percent test.

An Upper RIC will be treated as satisfying the 25 percent tests for a quarter provided that:

- (1) The Upper RIC invests solely in cash, cash items, Government securities, and securities of one or more Lower RICs, and each Lower RIC that is a member of the Upper RIC's controlled group, taking into account the market value exception and 30-day cure provision of section 851(d)(1), is treated as satisfying the 25 percent tests for each quarter that ends during or concurrently with the quarter of the Upper RIC; or

³ I.R.B. 2015-39.

- (2) The Upper RIC invests in cash, cash items, Government securities, and securities of one or more Lower RICs, and other stocks and securities, and
 - (a) Each Lower RIC that is a member of the Upper RIC's controlled group, taking into account the market value exception and 30-day cure provision of section 851(d)(1), satisfies the 25 percent tests for each quarter that ends during or concurrently with the quarter of the Upper RIC; and
 - (b) Disregarding the Upper RIC's investments in the securities in each Lower RIC that is a member of the Upper RIC's controlled group and the Upper RIC's proportionate share of any securities held by those Lower RICs, the Upper RIC satisfies the 25 percent tests with respect to the remainder of its assets.

An Upper RIC must now exercise care to ensure that its assets, apart from its investments in controlled RICs, satisfy the 25 percent test when those remaining assets are viewed on a stand-alone basis (i.e. the denominator will not include the investments in the controlled RICs). To the extent that such other assets constitute a small proportion of the value of the RIC's total assets, a relatively small investment in a single stock or security could cause the RIC to fail to qualify for the above safe harbors.

In determining whether a RIC within a chain of corporations satisfies the requirements of this revenue procedure, the 25 percent tests (taking into account the market value exception and 30-day cure provision of section 851(d)(1)), are applied:

- (1) First, to a Lower RIC that is not also an Upper RIC in the chain; and
- (2) Next, successively up the chain to each other Lower RIC in the chain; and
- (3) Last, to the Upper RIC that is not also a Lower RIC.

This revenue procedure is effective for quarters ending after September 14, 2015.

Two examples of practicability of an Upper RIC satisfying the 25 percent tests

For example, a RIC (RIC A) has a quarterly testing date of March 31 and lower RICs (RIC B, RIC C) are members of RIC A's controlled group and these RICs each have a quarterly testing date of February 28.⁴ RIC A's other investments are solely cash and government securities. On February 28, RIC B satisfies the 25 percent tests. RIC C, however, fails to satisfy one of the 25 percent tests on February 28 due its holdings of a Corporation A. On March 15, which is within 30 days after the close of the quarter ending February 28, RIC C sells shares of Corporation A so that the requirements of Section 851(b)(3)(B) are now met, RIC C is therefore considered to have met the 25 percent tests at the close of the quarter ended February 28. As a result, RIC A is treated as satisfying the 25 percent tests for its quarter ending March 31. This is because each lower RIC that is a member of RIC A's controlled group, now satisfies the 25 percent tests for each quarter that ends during or concurrently with the quarter of RIC A.

A second example, RIC A has a quarterly testing date of June 30. RIC A invests in shares of RIC B. RIC B is a member of RIC A's controlled group and has a quarterly testing date of May 31.⁵ RIC A's other investments are solely cash and government securities. RIC B's investment in Corporation A increases in value during the quarter ended May 31, with the result that more than 25 percent of RIC B's assets is invested in Corporation A. Taking into account the aforementioned market value exception, RIC B satisfies the 25 percent tests for the quarter ended May 31. During June, RIC B acquires additional interests in Corporation A. As a result, RIC A is treated as having satisfied the 25 percent tests for its quarter ended June 30th. This is because RIC B, taking into account the market value exception of section 851(d)(1), satisfies the 25 percent tests for its quarter that ends during or concurrently with the quarter of RIC A, and disregarding RIC A's investments in the stock and securities of RIC B, RIC A satisfies the 25 percent tests with respect to the remainder of its assets.

⁴ RIC A's Fund of Funds structure does not have a purpose of enabling RIC A to invest (directly or indirectly through one or more members of RIC A's controlled group) in securities of an issuer or category of issuers at levels that would not be permissible if the 25 percent tests were applied without regard to this revenue procedure.

⁵ Ibid

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