

IRS issues proposed regulations relating to the income and asset diversification requirements for Regulated Investment Companies

On September 27, 2016, the Internal Revenue Service (IRS) and the U.S. Department of the Treasury (Treasury) released proposed amendments to Income Tax Regulation 1.851-2 relating to the income and asset diversification requirements of a Regulated Investment Company (RIC). In addition, the IRS also issued Revenue Procedure 2016-50 addressing the IRS issuance of letter rulings with respect to whether or not an instrument is a security under the Investment Company Act of 1940 (40 Act).

Background

Generally to be treated as a RIC for the taxable year, a fund has to meet the income test and asset diversification test under IRC Section 851(b). The income test requires that at least 90% of its income is derived from qualifying income items such as dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income derived with respect to its business of investing in such stock, securities, or currencies, and net income derived from an interest in a qualified publicly traded partnership.¹ For purposes of the income test, securities are defined by reference to section 2(a)(36) of the 40 Act.

The asset test requires that at least 50 percent of the value of its total assets is represented by:

1. Cash and cash items, government securities, securities of other regulated investment companies, and other securities in respect of any one issuer to an amount not greater in value than five percent of the value of the total assets of the taxpayer and to not more than 10 percent of the outstanding voting securities of such issuer, **and**
2. Not more than 25 percent of the value of its total assets is invested in the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer, the securities (other than the securities of other regulated investment companies) of two or more issuers which the taxpayer controls and which 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 the securities of one or more qualified publicly traded partnerships.²

For purposes of the asset test, the term "security" has the same meaning as when used in the 40 Act.³ An investment is therefore generally a security for purposes of the income test and the asset diversification test if it is a security under the 40 Act.

In the past, the IRS has addressed the issue of whether or not instruments or positions are securities for purposes of section 851. For example, Revenue Ruling 2006-1 addresses the treatment by a RIC of certain derivative contracts on commodity indices and concludes that they are not securities for purposes of the income test. Revenue Ruling 2006-31 clarifies Revenue Ruling 2006-1 by stating that Revenue Ruling 2006-1 was not intended to preclude a conclusion that income from certain types of instruments, such as structured notes, that create commodity exposure could generate

¹ IRC Section 851(b)(2)

² IRC Section 851(b)(3)

³ IRC Section 851(c)(6)

qualifying income under Section 851(b)(2). Following the issuance of Revenue Ruling 2006-31, the IRS received a number of requests for Private Letter Rulings (PLR) concerning whether certain instruments that provide commodity exposure are securities. In July 2011, the IRS notified taxpayers that it would not issue further PLRs concerning RIC investments in commodities while the IRS reviewed issues such as if congress intended RICs to gain commodity exposure.

The preamble to the proposed regulation broadly states:

“Section 38 of the 1940 Act [...] grants exclusive rulemaking authority under the 40 Act to the Securities and Exchange Commission (SEC), including "defining accounting, technical, and trade terms" used in the 1940 Act. Any future guidance regarding whether particular financial instruments, including investments that provide RICs with commodity exposure, are securities for purposes of the 1940 Act is therefore within the jurisdiction of the SEC.”

The IRS stated it will no longer issue guidance relating to the qualification of an entity as a RIC if there is a requirement to determine whether or not an instrument or position is a security for purposes of the 40 Act. The IRS contemporaneously issued Revenue Procedure 2016-50 manifesting this position. This revenue procedure applies to all requests for letter rulings, including any requests pending in the national office and any requests submitted on or after September 27, 2016.

Investments in Controlled Foreign Corporations and Qualified Electing Funds

RICs that invest in certain controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs) may be required to include subpart F income⁴ and Qualified Electing Funds (QEFs) ordinary income and net capital gains⁵ in taxable income whether or not they receive a distribution from the foreign corporation. For RIC qualification purposes, these inclusions are generally considered dividends if there is a distribution out of the foreign corporation's earnings and profits for the taxable year in which the income is attributable to.⁶ Additionally, the IRS has previously issued letter rulings that provide that subpart F and QEF income inclusions could qualify as other income derived with respect to the RIC's business of investing in stock. The proposed regulations state that subpart F and QEF income inclusions are **not** other income with respect to the RIC's business of investing in stock. The IRS indicated that the subpart F and QEF income inclusions will only be qualifying income if the distribution requirement allowing dividend treatment is met.

Request for Comments

The IRS and Treasury are requesting comments regarding whether previously issued guidance including, but not limited to, Revenue Ruling 2006-1 and Revenue Ruling 2006-31 should be withdrawn as of the date of publication in the Federal Register of a Treasury decision adopting these proposed regulations as final.

Effective Date

Written or electronic comments and request for a public hearing must be received by December 27, 2016. The proposed regulations apply to taxable years that begin on or after the date that is 90 days after the date of publication in the Federal Register of a Treasury decision to adopt the proposed regulations as final.

Observations

1. RICs with offshore subsidiaries will need to consider distributing any subpart F income inclusion during the taxable year of the subsidiary. However, the amount of the inclusion may not be determinable until after year-end. This could require RICs to estimate the amount prior to year-end and address any variances after a final determination is made.
2. RICs investing in PFICs and making a QEF election with respect to those PFICs may not be able to control the amount and timing of distributions from those entities. This could require those RICs to choose a mark to market election instead of a QEF election. This could negatively impact the RIC's tax efficiency.

⁴ IRC Section 951(a)

⁵ IRC Section 1293(a)

⁶ IRC Section 851(b)

3. RICs that have previously received a PLR regarding the treatment of their investments that produce commodity exposure need to consider the impact of these proposed regulations.
4. The public announcement that the SEC has exclusive authority for purposes of defining “security” may broadly affect RIC qualification, as well as other entity qualification requirements, beyond the commodity-related instruments of immediate concern.

For additional information or questions, please contact:

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