

Client Alert

Current Issues Relevant to Our Clients

November 25, 2015

IRS Issues Final Regulations and Other Guidance Addressing Mutual Fund Asset Diversification Rules

On September 14, the IRS issued final regulations under Section 851 of the Internal Revenue Code (the “Code”). The new regulations clarify that controlled groups under the rules for regulated investment companies (“RICs”) may consist of only two entities, rather than two levels of entities as some practitioners had believed. This may cause unanticipated attributions of ownership, which would disqualify some RICs from beneficial tax treatment. In addition, Rev. Proc. 2015-45 announced a safe harbor for the application of RIC diversification tests when a RIC owns assets indirectly through another RIC that has a different quarter-end date.

Background

To qualify as a RIC for federal income tax purposes, a fund must satisfy two diversification tests. First, the 50% diversification test requires 50% of a fund’s assets to be represented by cash, United States government securities, securities of other RICs and other securities, as long as the “other securities” of any single issuer do not amount to more than 5% of the value of the Fund’s assets and 10% of the outstanding voting securities of such issuer.

Second, the 25% diversification test limits the investment of the fund so that it may not invest more than 25% of the fund (1) in a single issuer (other than U.S. government securities or securities of other RICs), (2) in two or more issuers (other than the securities of RICs) that the Fund controls and that are engaged in the same, similar or related trades or businesses or (3) in the securities of one or more qualified publicly traded partnerships (“QPTPs”).¹ Both diversification tests are performed at the close of each quarter of the taxable year.²

For purposes of the diversification tests, a fund is deemed to proportionally own investments that are owned by members of its controlled group. Thus, a fund with less than 25% of its assets invested in QPTPs could fail the 25% diversification test if its controlled group invests in QPTPs.³ A controlled group means one or more chains of corporations connected through stock ownership if 20% 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 the RIC owns directly 20% or more of

the total combined voting power of all the classes of stock entitled to vote of at least one of the other corporations.

The “market value exception” allows a RIC to continue to qualify as a RIC in certain circumstances when market fluctuations would otherwise cause it to fail the diversification tests.⁴ If a RIC meets the asset diversification tests at the close of any quarter, it will not lose its status because of a discrepancy during a subsequent quarter between the value of its investments and the diversification requirements unless such discrepancy is the result of an acquisition (and the discrepancy exists immediately after the acquisition). In other words, a discrepancy in value that is not due to an acquisition will not cause a failure of the test for that quarter, as long as the RIC met the requirements at the end of a previous quarter.

If a RIC does fail a diversification test, the “30-day cure provision” allows forgiveness for failures if the discrepancy is eliminated within 30 days after the close of the quarter in which the acquisition took place.

Fund of Funds and Rev. Proc. 2015-45

Some practitioners were uncertain about how to determine whether an Upper RIC satisfies its 25% test when the Lower RIC uses the 30-day cure provision to prevent a violation or when the Upper and Lower RICs have different quarter end testing dates. The combination of these rules may not allow the 30-day cure provision and the market value exception to prevent the Upper RIC from failing the diversification tests.

In Revenue Procedure 2015-45, the IRS announced that an Upper RIC will be treated as satisfying the 25% test for a quarter in the following two situations. First, the Upper RIC will satisfy the test if (a) it invests solely in cash, cash items, government securities and securities of one or more Lower RICs and (b) 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, is treated as satisfying the 25% tests for each quarter that ends during or concurrently with the quarter of the Upper RIC.

Second, the Upper RIC will satisfy the test if (a) it invests in cash, cash items, and government securities, other RICs, and other securities, (b) each Lower RIC that is a member of the Upper RIC's controlled group satisfies the 25% test for each quarter that ends during or concurrently with the quarter of the Upper RICs, taking into account the market value exception and 30-day cure provision, and (c) 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% test with respect to the remainder of its assets.

This rule does not apply if the purpose of the structure is to allow the Upper RIC to violate the 25% test. For example, the revenue procedure would not apply if direct or indirect transfers of assets are made among controlled group members, or if controlled group members otherwise acquire or transfer assets, as part of a plan to enable each RIC to satisfy the 25% test on each of its quarter-end dates while maintaining an investment that would otherwise violate the 25% test.

The 25% test for fund of funds structures (taking into account the market value exception and 30-day cure provision) is applied in this order:

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

Controlled Group Rules Apply to the QPTP Limitation

When QPTPs were added to the 25% diversification test, corresponding updates were not made to the controlled group test in Section 851(c). The controlled group test refers to the value of the taxpayer's investment in "an

issuer" and does not include a specific reference to the QPTP limitation, which is actually a limitation on a category of issuers. Furthermore, the regulations, prior to recent amendments, on the controlled group test referred to the taxpayer's investment in the securities of "any one issuer." Some practitioners have argued that the controlled group rules do not apply to the 25% limit on QPTPs for these reasons.

In the preamble to the finalized RIC regulations, the IRS clarifies that the controlled group rules also apply to interests in QPTPs. The IRS argues that Code Section 851(c) explicitly states that the controlled group rules are applicable to Section 851(b)(3), which contains the QPTP limitation. Also, the final regulations include an example in which a RIC loses its status because of excess indirect investment in QPTPs.

Controlled Groups May Consist of Only Two Entities

Some practitioners have interpreted the examples in the regulations to mean that a controlled group could not consist of only two entities. The IRS has changed two examples and added a third example to illustrate that two entities may constitute a controlled group. The IRS position is that the controlled group rules for RIC purposes were based on the "affiliated group" rules in the predecessor to current Section 1504 and the controlled group rules of Section 1563(a)(1), which allow for consolidated treatment regardless of whether the first subsidiary controls another subsidiary.⁵

In Example 1, Company W owns all of the voting stock of Corporations A and B. In the prior version of the regulations, Example 1 stated that none of the corporations in the example was a member of a controlled group, even though Investment Company W owned all the voting stock of Corporations A and B. The new regulations clarify that Corporation A and Corporation B are in controlled groups with Investment Company W, even though Corporations A and B did not control other subsidiaries. The previous statement that they were not a controlled group was intended to indicate that the subsidiaries did not control other subsidiaries.

Effective Date

The finalized regulations apply to quarters beginning after December 14, 2015. However, for purposes of applying the market value exception rule to a quarter that begins on or after March 14, 2016, the new regulations apply in determining whether the taxpayer met the requirements of the diversification tests at the close of prior quarters.

Therefore, the new rules are partially retroactive: if a RIC would not have qualified under the final regulations for its first quarter and any subsequent quarter in which an acquisition occurred, then it cannot take advantage of the market value exception for a quarter beginning after March 14, 2016.

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- 1 Code Section 851(b)(3)(B).
 - 2 Code Section 851(b)(3).
 - 3 Code Section 851(c).
 - 4 Code Section 851(d).
 - 5 TD 9737 (9/14/2015).

For More Information

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