Treasury Issues Proposed Regs Clarifying RIC Controlled Group Rules

by Amy S. Elliott and Lee A. Sheppard

On August 1, Treasury issued proposed regulations clarifying that the regulated investment company controlled group rules under section 851(c) only require the presence of two corporations -- not two levels of controlled entities -- in order for a controlled group to exist.

If the rules (REG-114122-12) are finalized and Treasury makes clear that a RIC and its wholly owned subsidiary constitute a controlled group, RICs might arguably have a tougher time satisfying the asset diversification test, threatening their RIC status and potentially exposing them to penalties.

"The regs were a little bit unexpected," Stephen D. Fisher of EY told Tax Analysts. "They appear to be directed at investments in master limited partnerships [(MLPs)]."

Fisher said some RICs have evidently been taking the position that they can invest 25 percent of their assets in an MLP directly and then invest an additional 25 percent indirectly through a wholly owned subsidiary. "These regulations were designed to prevent that second indirect investment," he said.

Susan Johnston of Ropes & Gray LLP is the author of the treatise *Taxation of Regulated Investment Companies and Their Shareholders*, which suggests that under the current regulations, a controlled group exists only where there are at least two levels of controlled entities.

"The fact that the Treasury proposes to act prospectively is sensible on its part, as it suggests to me that the Treasury is open to what people have to say on this question -- that is, they think that it was not something that people were consciously trying to abuse or to take advantage of, but rather, that there was good faith either (a) confusion, or (b) debate going on as to what these words meant," Johnston said.

"These proposed RIC regulations, if adopted, would clarify the look-through rules that apply to IRC section 851(c)(3)'s definition of 'controlled group' as applied to section 851(b)(3) asset diversification rules," said Joseph Riley of Willkie Farr & Gallagher LLP.

Background

Under section 851(b), a RIC, commonly called a mutual fund, has to meet certain election, gross income, and diversification requirements, including the section 851(b)(3) asset diversification test. Among other things the test generally requires that not more than 25 percent of the total value of the RIC's assets can be invested (1) in the securities of any one issuer, (2) in the securities of two or more issuers controlled by the RIC and in a similar trade or business as the RIC, or (3) in the securities of one or more qualified publicly traded partnerships (PTPs).

The section 851(c) controlled group rules, which were modeled after the affiliated group rules in section 1504(a), help RICs determine whether they satisfy the second prong of the section 851(b)(3)(B) asset diversification test. "It should be noted that the proposed regulations by their terms apply only to the 25 percent RIC asset diversification limits, not to the more general 50 percent asset diversification limits," Riley noted.

In 1957, Treasury adopted regulations (T.D. 6236, 22 FR 3872) containing examples that illustrate how to apply the rules to test whether a company has more than 25 percent of its assets invested in the securities of two or more controlled issuers. The examples, in part, mirror "nearly verbatim" examples in legislative history to the 1942 enactment of the RIC rules, subchapter M of the code, according to Treasury's preamble.

In 1942, RICs could not be affiliated corporations (later redefined as members of an affiliated group) according to statute. So RIC advisers thought a reasonable interpretation of original intent would be that RICs were excluded from the definition of controlled group as well, as the original examples imply.

"It is not every day that seventy-year-old examples in Treasury regulations are proposed to be rewritten, especially examples drawn directly from a House committee report," said Riley.

Need for Change

Treasury wrote that "some practitioners have interpreted section 851(c)(3) to require the presence of two levels of controlled entities for a controlled group to exist, and have relied on certain of the examples in the regulations, and the 1942 legislative history, to support this interpretation. The IRS and Treasury Department believe that this interpretation is unwarranted."

Section 851(c)(3) refers to "one or more chains of corporations connected through stock ownership with the taxpayer." Some taxpayers may have taken the position that a RIC was only in a controlled group with its wholly owned subsidiary if that subsidiary controlled another subsidiary. Apparently a chain has to have more than one link. That is, two corporations would not form a controlled group, so three would be necessary.

Under this view, if a RIC had a wholly owned subsidiary that didn't control another entity, the RIC could arguably indirectly invest in securities through its wholly owned subsidiary. It could then take the position that those securities wouldn't count for purposes of the asset diversification test applied to the parent.

According to the preamble, the language in the example and the legislative history "was intended merely to simplify the description of certain fact patterns, and not to articulate a legal interpretation that is inconsistent with the construction of substantially similar language elsewhere in the Code." Treasury pointed out that a parent and its subsidiary are treated as affiliated under section 1504(a)(1) and as a controlled group under section 1563 regardless of whether the subsidiary controls another entity.

The proposed regs make changes to examples 1 and 4 in reg. section 1.851-5 to clarify that a wholly owned subsidiary of a RIC is a member of the RIC's controlled group whether or not the subsidiary controls another entity.

The proposed regs also add a new example (Example 7) that illustrates application of the third prong of the section 851(b)(3)(B) asset diversification test regarding securities of qualified PTPs. The regs update the dates used in the examples to the current year, and also add citations for additional clarity. A public hearing on the proposed regs is scheduled for December 9, and comments are due by October 31.

Johnston said the position Treasury is taking in the proposed regs "is not the easier reading of the statute." She notes further, as a policy matter, the limitation on qualified PTPs was aimed at preventing the use of RICs as effectively connected income and unrelated business taxable income blockers, and owning the same through a controlled corporation does not subvert that purpose. She said that if the guidance is finalized, "there are some RICs that may well choose to alter their structure, really change the way in which they conduct their investment activities."

Fisher agreed. "It is a bit of a stretch," he said. "It's weird as a policy matter that you would need two levels of control [to have the look-through]. But that is the plainest reading of the Internal Revenue Code. So if that's what the code says, you can't really change it with regulations."

Fisher said the issue doesn't tend to come up outside of the MLP context, because a general-purpose RIC "typically just doesn't make concentrated investments" in one issuer. Because of that, he said, "there may not be a lot of people who care that much about the issue."

Correction, August 2, 2013. A parent and its subsidiary are treated as affiliated under section 1504(a)(1) and as a controlled group under section 1563 regardless of whether the subsidiary controls another entity.