

Proposed RIC Rules Look To SEC to Define Security

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Proposed regulations on regulated investment companies' commodity investments and a related no-rule revenue procedure were issued on September 27.

The proposed regulations (REG-123600-16) address the RIC income test and asset diversification requirements. For purposes of the income test and the asset diversification requirements, an asset is a security if it is a security under the Investment Company Act of 1940. The preamble notes that the government has previously addressed whether specific instruments or positions are securities for purposes of section 851 but states that "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 . . . within the jurisdiction of the SEC."

Section 851(b)(2) requires that a RIC derive at least 90 percent of its gross income from specific sources, including dividends, interest, gains from the sale or other disposition of stock, securities, or foreign currencies, and "other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities or currencies." The proposed regulations provide that income inclusions under section 951 (for controlled foreign corporations) and under section 1293 (for passive foreign investment companies) will be treated as dividends for purposes of section 851(b)(2) only if actual distributions attributable to those inclusions are made.

The proposed rules provide that CFC income under section 951 and PFIC income under section 1293 will be treated as dividends for purposes of section 851(b)(2) only if the actual distribution requirements are met. The proposed rules also provide that an inclusion under section 951(a)(1) or 1293(a) does not qualify as other income derived from a RIC's business of investing in stock, securities, or currencies.

Helen Hubbard, IRS associate chief counsel (financial institutions and products), confirmed September 26 that if a CFC holds commodity investments, even though the CFC's actual distributions would qualify as income, its deemed distributions would not. Speaking at the Investment Company Institute Tax and Accounting Conference in Palm Desert, California, Hubbard said the IRS

will address what constitutes a distribution under section 851 in future guidance.

One of the first questions taxpayers and practitioners will have regarding the proposed regulations is what will happen to the 72 letter rulings the IRS issued to mutual fund complexes saying that income from a CFC is qualifying income under section 851(b)(2), regardless of whether distributed to the RIC, said Richard C. LaFalce of Morgan, Lewis & Bockius LLP. The proposed guidance does not answer that question.

Hubbard said that for "existing rulings issued and pending, we will be working through those issues after the guidance is published."

From 2006 to 2011, the IRS issued letter rulings to RICs on whether an instrument was a security for purposes of section 851, allowing them to invest indirectly in commodities through structured notes or CFCs and treat the income as qualifying income. Many of those letter rulings include a ruling that income inclusions from CFCs are other income derived from a RIC's business of investing in stock, securities, or currencies, whether or not the CFCs make distributions. The IRS temporarily suspended rulings on RICs' investment in commodities in a "pause" that has continued for the past five years. (Prior analysis: *Tax Notes*, Aug. 1, 2011, p. 468.)

Hubbard said with the new guidance, the IRS won't issue any letter rulings concerning a RIC's commodity investments under section 851.

"There is a very strong indication that going forward, [the IRS and Treasury] no longer believe you can have qualifying income from a CFC unless you have distributions," said LaFalce.

'The IRS had to do something to address the backlog of letter ruling requests and the criticism it received for issuing the prior 72 rulings,' LaFalce said.

The IRS and Treasury's revival of the question of how to interpret section 851(b), after a five-year hiatus, may be a matter of administrative necessity. LaFalce said many tax practitioners agreed with the CFC letter rulings that the other income clause in section 851(b)(2)(A) was broad enough to cover income inclusions from CFCs, despite the flush language at the end of subsection 851(b) that treats PFIC inclusions and subpart F income as dividends to the extent there is a distribution. Many thought the interpretation in the letter rulings was a good interpretation of the law, he said. The catalyst for the new guidance was probably the criticism the IRS received from then-Sen. Carl Levin, who viewed the rulings as allowing an end run around

what constitutes qualifying income, LaFalce said. "The IRS had to do something to address the backlog of [letter ruling] requests and the criticism it received for issuing the prior 72 rulings," he said. (Prior coverage: *Tax Notes*, Jan. 30, 2012, p. 524.)

If the proposed rules are finalized in substantially the same form, RICs that were not making distributions from CFCs will have to start doing so, and that will put greater pressure on valuing the CFCs, LaFalce said.

The proposed rules may have an unfortunate effect on whether derivative instruments produce qualifying income, LaFalce said, adding that "from a practical standpoint, it puts greater pressure on fund complexes to turn to '40 act lawyers to get an answer, and it may produce strange results." He said some traditional investments, including many that are not commodity related, are technically not securities under section 2(a)(36) of the 1940 act, although practitioners have always thought of them as producing qualifying income.

The new revenue procedure (Rev. Proc. 2016-50, 2016-43 IRB 1) provides that the IRS ordinarily will not issue rulings or determination letters on any issue regarding the treatment of a corporation as a RIC that requires a determination of whether a financial instrument or position is a security under the 1940 act. The preamble indicates that the change is the result of Treasury and the IRS's review of the issues as well as resource constraints. The government requests comments on whether previous guidance regarding determinations of whether a financial instrument or position held by a RIC is a security under the 1940 act should be withdrawn when the regulations are finalized. ■

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