The US Internal Revenue Service (IRS or Service) has issued guidance (REG 123600-16) relating to the regulated investment company (RIC) income test and asset diversification requirements as set forth in Internal Revenue Code 1 Section 851(b).

Background

Section 851 sets forth the rules for a company to qualify as a RIC. Section 851(b) provides both an income test and asset diversification requirements that must be met for a corporation to be treated as a RIC for a tax year. Both tests use the term “security,” that Section 851 defines by referencing the Investment Company Act of 1940 (the 1940 Act).

In the past, the IRS has received numerous letter ruling requests to define the term “security” for purposes of Section 851(b). In addition, the IRS has issued a number of letter rulings on whether amounts included in taxable income under Sections 951(a)(1)(A)(i) and 1293(a) can be included in gross income for purposes of meeting the Section 851(b) requirements. The proposed regulations specifically address these issues.

Section 7704(c) does not treat a publicly traded partnership (or MLP) as a corporation under Section 7704(a) if 90% or more of the gross income of the partnership for the tax year is “qualifying income.” Section 7704(d)(4) defines “qualifying income” for Section 7704(c) purposes to include any income that would be qualifying under Section 851(b)(2)(A).
Proposed regulations

Definition of security

The preamble to the regulations states that the Service will no longer issue rulings on the definition of “security” for Section 851(b) purposes. Revenue Procedure 2016-50 was released concurrently to provide that the “no-ruling” policy on these issues is effective as of 27 September 2016. The Service has also requested comments on whether Revenue Ruling 2006-1, Revenue Ruling 2006-31 and other previously issued guidance involving determinations of whether a financial instrument or position held by a RIC is a security under the 1940 Act should be withdrawn, effective as of the date of the finalization of the proposed regulations.

Income inclusion under Sections 951(a)(1)(A)(i) and 1293(a)

Section 851(b) currently provides that earnings of a foreign corporation that are included in taxable income by a US person under Sections 951(a)(1)(A)(i) and 1293(a) will be treated as dividends for Section 851(b) purposes only if the foreign corporation makes a corresponding distribution of cash or property to the US person. The IRS has issued numerous letter rulings allowing these amounts to be treated as “other income” under Section 851(b), even in the absence of a distribution.

The proposed regulations would clarify that earnings included under Sections 951(a)(1)(A)(i) and 1293(a) will be treated as dividends only to the extent that the distribution requirement is met. The proposed regulations also provide that, for purposes of Section 851(b)(2), income inclusions under Section 951(a)(1)(A)(i) and 1293(a) do not qualify as other income derived from a RIC’s business of investing in stock, securities or currencies.

Implications

The refusal of the Service to provide guidance on what constitutes a “security” for Section 851(b) purposes is disappointing and will likely increase uncertainty in the area or at least require determinations from the US Securities and Exchange Commission to address the tax issue.

After issuing numerous letter rulings on RICs gaining exposure to commodities through controlled foreign corporations or structured notes, the Service instituted an informal moratorium on further rulings while it studied the issues in response to Congressional and other comments. The proposed regulations and associated no-rule policy formalize that moratorium and begin a reversal of prior ruling policy. The Service’s proposed rules regarding income inclusions under Sections 951(a)(1)(A)(i) and 1293(a) represent a significant change to its prior ruling policy; taxpayers should reassess the effect that inclusions under Sections 951(a)(1)(A)(i) and 1293(a), without corresponding distributions, may have on their status as RICs.

Because income described in Section 851(b) can be treated as qualifying income for Section 7704(c) purposes, the proposed regulations should be considered in evaluating the amount of a publicly traded partnership’s gross income that is qualifying income under Section 7704(d).

Endnote

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
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