STRADLEY RONON

Tax Advisor

A Publication of the Stradley Ronon Tax Practice Group

WWW.STRADLEY.COM

OCTOBER 2015

Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York, N.Y.
Malvern, Pa.
Cherry Hill, N.J.
Wilmington, Del.
Harrisburg, Pa.

www.meritas.org

Our firm is a member of Meritas – a worldwide business alliance of more than 210 law offices in 70 countries, offering high-quality legal services through a closely integrated group of independent, full-service law firms.

Information contained in this publication should not be construed as legal advice or opinion or as a substitute for the advice of counsel. The enclosed materials may have been abridged from other sources. They are provided for educational and informational purposes for the use of clients and others who may be interested in the subject matter.

Copyright © 2015 Stradley Ronon Stevens & Young, LLP
All rights reserved.

Recent Guidance Excuses Funds of Funds From Broader Look-Through Rules When Applying 25 Percent Asset Diversification Test

by Jacquelyn Gordon and Roger Wise

The IRS recently finalized regulations, proposed in 2013 and updating rules otherwise untouched since 1957, to make clear when a regulated investment company (RIC) must take into account securities held by members of its “controlled group” for purposes of applying the 25 percent diversification requirement for RIC qualification. At the same time, the IRS released Revenue Procedure 2015-45, which sets forth a safe harbor to protect RICs that invest in other RICs (funds of funds) from the burdens and uncertainties created by the new regulations. The regulations are effective Sept. 15, 2015, and apply to quarters beginning on or after Dec. 14, 2015.

Final Regulations

In order to qualify for tax treatment as a RIC, among other things, at the end of each quarter no more than 25 percent of the value of the RIC’s total assets may be invested in the securities of

- any one issuer,
- two or more issuers which the RIC controls and which are engaged in the same or similar trades or businesses, or
- one or more qualified publicly traded partnerships (QPTPs).

A QPTP is a publicly traded entity, such as a master limited partnership, that is treated as a partnership for tax purposes and that predominantly earns income, such as commodity-related income, that would not qualify as “good” income for a RIC. Tax code amendments in 2004 permit RICs to treat income from QPTPs as qualifying income, subject to the 25 percent limitation, in order to improve QPTPs’ access to capital. The 25 percent diversification requirement applies to securities of QPTPs as a category, rather than to the securities of any particular issuer, as with all other types of securities.

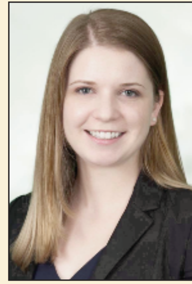
For purposes of the 25 percent diversification test, in ascertaining the value of its investment in the securities of an issuer, a RIC must include its “proper proportion” of the investment in those securities by any member of its “controlled group,” defined as one or more chains of corporations connected to the RIC through ownership of stock representing at least 20 percent of the total combined voting power of all classes of stock entitled to vote (control).

Under the previous regulations, it was unclear what constituted a "chain" under the controlled group definition. Many practitioners believed, based on the examples in the 1957 regulations, that a RIC was required to take into account a security held by a controlled subsidiary in applying the 25 percent test only if the subsidiary held a 20 percent control position in the issuer of that security. In other words, under this view two levels of control were needed before a RIC was required to "look through" to the underlying securities held by controlled group members. Based on this reading of the rules, some funds increased their investments in QPTPs by investing 25 percent of their assets directly in QPTPs and a second 25 percent in a wholly owned, but taxable, subsidiary that invested in additional QPTPs. We understand the IRS was concerned that, among other things, this interpretation appeared to require language in the RIC provisions of the tax code to be read differently from identical language in tax code provisions dealing with affiliated corporations.

The final regulations, which adopt the 2013 proposed regulations without substantive changes, make clear that a RIC must aggregate direct holdings and holdings of even a single 20 percent controlled subsidiary when applying the 25 percent test. That is, only one level of control is required. This means that a RIC investing 10 percent of its assets directly in QPTPs, and another 20 percent through a wholly owned subsidiary that in turn invests exclusively in QPTPs, would not satisfy the 25 percent test.

Generally speaking, the final regulations should not affect a RIC that makes a direct investment in a QPTP to increase its commodity exposure, where the RIC also has a wholly owned offshore subsidiary (classified as a controlled foreign corporation) holding commodity-related investments. The QPTP issuer will not be the same as the issuers of the subsidiary's investments, and those investments likely are not securities at any rate. The final regulations could apply, however, if the RIC and its subsidiary (even if offshore) hold securities of the same issuer. A RIC should also proceed with caution in using a derivative instrument to increase its QPTP exposure beyond 25 percent, although this point is not addressed in the final regulations.

A RIC that no longer satisfies the 25 percent test based on the final regulations will need to reevaluate its investment holdings so that it will still qualify for tax treatment as a RIC in the first quarter beginning on or after Dec. 14, 2015. Although a RIC may generally disregard changes in market value in applying the diversification tests, so long as the RIC met those tests at the end of a prior quarter, a RIC can rely on this market value exception for quarters beginning on or after March 31, 2016, only if the RIC was in compliance with the new regulations at the close of a prior quarter.



Jacquelyn Gordon

Roger Wise

For more information, contact Jacquelyn Gordon at 215.564.8176 or jgordon@stradley.com or Roger Wise at 202.419.8436 or rwise@stradley.com.

Fund of Funds Safe Harbor

Although the final regulations appear to have been aimed at, or at least inspired by, structures used by RICs to invest more than 25 percent of their assets (directly or indirectly) in QPTPs, the final regulations also apply to funds of funds. A fund of funds is a structure in which a RIC (Upper RIC) invests in the stock and securities of one or more lower-tier RICs (Lower RICs), usually in the same fund family. The final regulations could require an Upper RIC with a control position in a Lower RIC to take into account securities positions of the Lower RIC, even if the RICs were not in compliance on the same dates, because of different taxable years or because of reliance on the market value exception or an exception permitting a RIC to correct diversification problems within 30 days after quarter-end.

The safe harbor in Revenue Procedure 2015-45 applies to Upper RICs that own 20 percent or more of voting stock of the Lower RICs. An Upper RIC that invests only in Lower RICs will be treated as satisfying the 25 percent test if each Lower RIC, starting with the lowest RIC in the chain, satisfies the 25 percent test on the quarter ending during or concurrently with the quarter of the Upper RIC. If an Upper RIC invests in both Lower RICs and other securities, the Lower RICs and the other securities must independently satisfy the test. The safe harbor does not apply if a purpose of the fund of funds structure is to enable an Upper RIC to invest in securities of an issuer that would not be permissible if the 25 percent test was applied without regard to the revenue procedure.

© 2015 Stradley Ronon Stevens & Young, LLP