



# TaxNewsFlash

## United States

No. 2016-434  
September 27, 2016

### **Proposed regulations: RIC qualifications; income test and asset diversification requirements**

The Treasury Department and IRS today released for publication in the Federal Register proposed regulations (REG-123600-15) concerning corporations seeking to qualify as a regulated investment company (RIC).

The [proposed regulations](#) [PDF 225 KB] provide guidance relating to the income test and the asset diversification requirements that apply in determining whether RIC status has been met. Comments and requests for a public hearing must be received by a date that is 90 days after the proposed regulations appear in the Federal Register on September 28, 2016.

In conjunction with the proposed regulations, the IRS also issued an advance version of [Rev. Proc. 2016-50](#) [PDF 11 KB] providing that the IRS ordinarily will not issue rulings or determination letters on any issue relating to the treatment of a corporation as a RIC that requires a determination of whether a financial instrument or position is a "security" for purposes of RIC status.

### **Background**

A corporation must satisfy two requirements to be treated as a RIC for a tax year:

- The income test of section 851(b)(2)
- The asset diversification requirements of section 851(b)(3)

The preamble to today's proposed regulations explains that previously, the IRS addressed whether certain instruments or positions were securities for purposes of section 851. Rev. Rul. 2006-1 concluded that a derivative contract with respect to a commodity index was not a security, and that income from such a derivative contract was not "qualifying other income." Subsequently, the IRS issued Rev. Rul. 2006-31 that clarified that Rev. Rul. 2006-1 was not intended to preclude a conclusion that

income from certain instruments (e.g., certain structured notes) that create commodity exposure for the holder was qualifying income.

As further explained in the preamble to the proposed regulations, the IRS found it was then “devoting substantial resources” to address private letter ruling requests as to whether certain instruments that provided RICs with commodity exposure were securities. The IRS in 2011 announced it would no longer issue private letter rulings addressing specific proposed RIC commodity-related investments pending review of the issue by the IRS. Eventually, the IRS found that making a determination whether certain investments that provide RICs with commodity exposure were securities actually was within the scope of the authority of the U.S. Securities and Exchange Commission (SEC).

### **Proposed regulations**

The proposed regulations state that the IRS and Treasury have determined that the IRS will no longer issue letter rulings on questions relating to the treatment of a corporation as a RIC if it requires a determination of whether a financial instrument or position is a security.

Today’s related revenue procedure—Rev. Proc. 2016-50—also provides that the IRS “ordinarily” will not issue rulings or determination letters on any issue relating to the treatment of a corporation as a RIC that requires a determination of whether a financial instrument or position is a security. For example, the IRS will not issue a ruling on whether income is of a type described under the “income test” if that ruling depends on whether an instrument is a security.

Today’s releases request comments as to whether the earlier revenue rulings or other prior guidance involving a determination of whether a financial instrument or position held by a RIC is a security need to be withdrawn, as of the effective date of regulations that finalized today’s proposed regulations.

### **Earnings of foreign corporations**

The proposed regulations also address the treatment of earnings of a foreign corporation included in a RIC’s gross income under section 951(a)(1)(A)(i) or section 1293(a) as a dividend that is qualifying income under section 851(b)(2), subject to a condition that there was a distribution from the foreign corporation’s earnings and profits which was attributable to the amount included.

The preamble to the proposed regulations explains that the IRS previously issued letter rulings to permit an inclusion under section 951(a)(1)(A)(i) or section 1293(a) to qualify as “other income” derived with respect to a RIC’s business of investing in currencies or securities, even absent a distribution. As further explained, this treatment “ignores the requirement in section 851(b) that amounts be distributed in order to treat these inclusions as dividends.”

Accordingly, the proposed regulations specify that an inclusion under section 951(a)(1)(A)(i) or section 1293(a) is treated as a dividend under section 851(b) only to the extent that the distribution requirement is met. The proposed regulations also provide that an inclusion does not qualify as “other income” with respect to a RIC’s business of investing in stock, securities, or currencies.

This rule will apply to tax years that begin on or after a date that is 90 days after the date of publication in the Federal Register of the regulations that adopt and finalize these proposed regulations.

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