By Electronic Delivery

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Internal Revenue Service
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RE: Comments on Proposed Regulations under Section 851 on Controlled Groups (REG-114122-12)

Dear Mr. Novey and Ms. Hubbard:

The Investment Company Institute\(^1\) appreciates this opportunity to comment on the recently proposed regulations under section 851(c) regarding the definition of a “controlled group” for purposes of the asset diversification test applicable to regulated investment companies (“RICs”). We support the efforts of the Internal Revenue Service (“IRS”) and the Treasury Department to update and clarify the rules in this area.

We believe, however, that the proposed regulations could have unintended consequences for “fund of funds” structures. Investment in the securities of another RIC is a *per se* good investment for purposes of both the income and diversification tests in Subchapter M, so long as the lower-tier RICs satisfy their quarterly and annual tests. Application of the controlled group rules should not change this result. We are concerned, however, that the controlled group rules, as clarified in the proposed regulations, could require upper-tier funds to undertake unnecessary and burdensome testing and

\(^1\) The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $15.2 trillion and serve more than 90 million shareholders.
recordkeeping to document that they are in compliance with the asset diversification tests of section 851(b), taking into account the assets of the lower-tier funds.

We thus ask the IRS and Treasury Department to confirm that an upper-tier RIC will not fail its diversification test solely by reason of its investment in other RICs. The government can do so by providing a safe harbor to the controlled group rules, pursuant to which an upper-tier RIC in a fund of funds structure will satisfy the 25% test in section 851(b)(3)(B), if: (i) All of the lower-tier RICs satisfy the asset diversification test, including by reason of any cures under section 851(d): and (ii) To the extent that the upper-tier RIC has direct investments, its investment in any one issuer (not including any indirect exposure to that issuer through a lower-tier RIC) does not exceed 25% of its total assets, excluding from the total the securities of other RICs.

We also question whether the controlled group rules should apply with respect to the 25% aggregate limitation on a RIC’s ownership of interests in qualified publicly traded partnerships (“QPTPs”) in section 851(b)(3)(B)(iii). As explained below, if a RIC holds shares in a fully taxable corporation which invests in master limited partnerships (“MLPs”), the purposes of the 25% aggregate limitation on QPTP investment have been satisfied, and further restrictions are unnecessary.

Finally, we suggest that the IRS and the Treasury Department amend Treas. Reg. § 1.851-3 to include language articulating the key aspects of the controlled group rules, rather than simply updating the examples in Treas. Reg. § 1.851-5.

DISCUSSION

In order for a mutual fund to qualify as a RIC under Subchapter M of the Internal Revenue Code, the fund must satisfy both an income test and an asset diversification test, as set forth in section 851(b)(2) and (3), respectively. The asset diversification test, to which the proposed regulations pertain, includes a 50% test and a 25% test, both of which are applied at the close of each quarter of the fund’s taxable year. The 50% test requires a fund to have at least 50% of its total assets invested in (i) cash, cash items, government securities, and securities of other RICs; and (ii) other securities, generally limited to 5% of the total assets of the fund with respect to any one issuer and no more than 10% of the outstanding voting securities of such issuer. The 25% diversification test requires a fund to have no more than 25% of the value of its total assets invested in (i) the securities of any one issuer, other than government securities or the securities of another RIC; (ii) the securities (other than the securities of another RIC) of two or more issuers that the taxpayer controls and that are engaged in the same or similar trades or businesses or related trades or businesses, or (iii) the securities of one or more QPTPs.

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2 Section 851(b)(3)(A).
3 Section 851(b)(3)(B).
Section 851(c) contains special rules applicable to the 25% asset diversification test in section 851(b)(3)(B). Specifically, it provides that, in determining the value of a RIC’s investment in the securities of any issuer, the RIC must include its proportionate investment in securities held through any members of a “controlled group.”

The statute provides:

The term “controlled group” means one or more chains of corporations connected through stock ownership with the taxpayer if—

(A) 20 percent or more of the total combined voting power of all classes of stock entitled to vote of each of the corporations (except the taxpayer) is owned directly by one or more of the other corporations, and

(B) The taxpayer owns directly 20 percent or more of the total combined voting power of all classes of stock entitled to vote, of at least one of the other corporations.

The controlled group rules thus require a RIC to aggregate the interests held by other members of a controlled group in a single issuer for purposes of determining whether the RIC has satisfied the 25% diversification test.

The ambiguous language of the statute, together with the examples in the legislative history and Treas. Reg. § 1.851-5, have led many in the industry to believe that the rules require a subsidiary of a RIC to control another corporation in order to constitute a controlled group. The IRS and Treasury Department, however, disagree with this interpretation. The proposed regulations thus would modify the examples in Treas. Reg. § 1.851-5 to clarify that the controlled group rules under section 851(c) apply if a RIC holds 20% or more of the total voting stock of a corporation, even if that corporation does not control another corporation. The proposed regulations also would add a new example to illustrate the application of the controlled group rules with respect to a RIC’s investment in interests issued by MLPs.

Fund of Funds

The proposed regulations raise a number of practical issues for fund of funds structures. In this common structure, an upper-tier RIC holds shares in one or more lower-tier RICs. This product provides investors with an asset allocation vehicle, allowing them to rely upon the fund manager to invest in various underlying funds with different investment objectives. This permits the investor to diversify his or her portfolio without having to invest in each fund individually. Target-date funds, for example, invest in equity and bond funds based upon the investment timeline of the upper-tier RIC investors; the ratio of equity to debt changes as the investors’ target date nears. The lower-tier RICs

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4 Section 851(c)(1).

5 The Internal Revenue Code does not limit the percentage of the upper-tier RIC’s assets that may be invested in lower-tier RICs.
typically are part of the same fund family as the upper-tier RIC, but they do not have to be, and some funds invest in unaffiliated RICs. The upper-tier RIC typically invests only in other RICs; however, the upper-tier RIC may make direct investments as well.

**Upper-Tier RIC Invests Solely in Shares of Other RICs**

As a general proposition, if an upper-tier RIC invests solely in the shares of other RICs that it controls within the meaning of section 851(c), the controlled group rules (as interpreted under the proposed regulations) should not cause the upper-tier RIC to fail the diversification test, as long as each lower-tier RIC satisfies the diversification test. In order to satisfy the diversification test, each lower-tier RIC can have no more than 25% of its assets in the securities of any one issuer. Because the upper-tier RIC is deemed to hold its proportionate share of each lower-tier RIC’s assets, if each lower-tier RIC satisfies the asset diversification test, then the upper-tier RIC cannot have more than 25% of its assets in securities of a single issuer.

**Example:** Upper RIC owns 30% of the outstanding voting stock of Fund A, Fund B, and Fund C, all of which are RICs. Forty percent of Upper RIC’s assets are invested in Fund A; the remaining 60% of Upper RIC’s assets are invested equally in Funds B and C. Funds A, B, and C each has 25% of its assets invested in securities issued by Corp Z. Because Upper RIC holds more than 20% of each of the lower-tier funds, Upper RIC and Funds A, B, and C are considered a controlled group, and Upper RIC must aggregate the investments held by each of the lower-tier RICs for purposes of the 25% asset diversification test. To determine Upper RIC’s total investment in Corp Z, the fund must multiply the percentage of each lower-tier fund’s assets invested in Corp Z by the portion of Upper RIC’s assets invested in each lower-tier fund. The percentage of Upper RIC’s assets invested in Corp Z through Fund A is 10% (40% x 25%). The percentage of Upper RIC’s assets invested in Corp Z through Funds B and C is 7.5% each (30% x 25%). Thus, the total percentage of Upper RIC’s assets invested in Corp Z is 25% (10% + 7.5% + 7.5%). Upper RIC has not failed the asset diversification test under the controlled group rules.

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6 Section 12(d)(1)(A) of the Investment Company Act of 1940 (the “40 Act”) prohibits a registered investment company from acquiring shares of an investment company if the securities represent more than 3% of the total outstanding voting stock of the acquired company, more than 5% of the total assets of the acquiring company, or, together with the securities of any other investment companies, more than 10% of the total assets of the acquiring company. Section 12(d)(1)(G) provides an exception for affiliated funds. Section 12(d)(1)(J) of the ‘40 Act allows the Securities and Exchange Commission (“SEC”) to provide exemptive relief from these limitations if the exemption is consistent with the public interest and the protection of investors. Because section 12(d) was enacted to prevent layering of multiple fees upon investors, the SEC has issued exemptive orders permitting funds to hold up to 25% of the outstanding voting securities of non-affiliated funds, provided that certain conditions are satisfied to prevent multiple fees.

7 For purposes of this discussion, we are ignoring cash, cash items, and government securities.
As a mathematical matter, an upper-tier RIC should not fail the asset diversification test due to assets held by lower-tier RICs that satisfy the 25% asset diversification test. As described below, however, there are technical issues that could cause an upper-tier RIC to fail if the controlled group rules were applied. These issues could be resolved by providing that an upper-tier RIC will be deemed to satisfy the 25% diversification test so long as the lower-tier RICs have satisfied the requirements. Such a rule is logical, given that the investors in the upper-tier fund could have invested directly in each of the underlying funds without negative tax consequences. The convenience of the fund of funds structure should not result in disparate tax treatment for investors.

**Different Quarter-Ends**

One such technical issue could arise in a fund of funds structure if one or more of the lower-tier funds have a different quarter-end than the upper-tier fund. In this event, on the last day of the upper-tier fund’s quarter, a lower-tier fund could have an investment that exceeds the 25% limitation in section 851(b)(3)(B). The lower-tier fund would not have failed the diversification test because its quarter will have not yet ended, and the lower-tier fund likely would adjust its portfolio to come within the limits by the end of its quarter. This mismatch of quarters, however, could cause the upper-tier fund to fail the diversification test. This problem may be exacerbated if the funds are unaffiliated; the upper-tier RIC may not have access to the specific investments of the lower-tier fund, as the lower-tier fund may only disclose its holdings quarterly. This issue can be avoided by confirming that an upper-tier fund satisfies the 25% test so long as the lower-tier RICs have done so.

We note that a RIC’s investment in another RIC is a *per se* good investment for all other purposes of the diversification tests so long as the lower-tier RIC satisfies its quarter-end and annual requirements to qualify as a RIC. Application of the controlled group rules should not change this result.

**Lower-Tier Fund Cures Diversification Failure**

Another issue may arise if a lower-tier fund fails the diversification test at the end of a quarter but then cures the failure within thirty days, as permitted under section 851(d)(1). This cure should apply to the upper-tier fund for purposes of determining whether the upper-tier RIC satisfies the diversification test at the end of the quarter. If the cure does not apply, however, the upper-tier fund could fail the 25% diversification test. Again, confirming that an upper-tier fund satisfies the 25% test so long as the lower-tier funds have done so would resolve this problem.

**Example:** Upper RIC holds more than 20% of the shares in each of Funds A, B, C, and D and has 25% of its assets invested in each fund. Each of the lower-tier funds has 25% of its assets invested in Corp Z. Fund A has controls in place intended to prevent it from exceeding the 25% limitation. Glitches occur, however, and Fund A purchases additional shares of Corp Z, bringing its total investment in Corp Z to 29%. Thus, Upper RIC’s total investment in Corp Z, through Funds A, B, C and D, is now 26% of
its assets (Upper RIC owns 6.25% each through Funds B, C, and D, and 7.25% through Fund A). At the end of the quarter, both Fund A and Upper RIC have failed the asset diversification test. Within 30 days of the end of the quarter, however, Fund A discovers the mistake and sells enough Corp Z shares to bring it back within the 25% limitation, curing the failure as set forth in section 851(d)(1).

In this example, Fund A does not lose its RIC status because it cures its diversification test failure. One also could read section 851(d) to provide that Upper RIC similarly does not lose its RIC status because (i) it is a “corporation” that does not meet the diversification requirements at the close of a quarter “by reason of a discrepancy existing immediately after the acquisition of any security” (i.e., Fund A’s purchase of Corp Z shares), (ii) the discrepancy is wholly or partly the result of that acquisition, and (iii) “such discrepancy is eliminated within 30 days after the close of the quarter” by Fund A. This reading suggests that Upper RIC should be deemed to satisfy the diversification test.

If the cure does not apply to Upper RIC, however, it will not maintain its RIC status. As Upper RIC has not made any additional acquisitions itself that gave rise to the failure, Upper RIC should not be required separately to cure the diversification test failure if Fund A disposes of the Corp Z shares within the 30 day period. If Upper RIC is required to separately cure the diversification test failure, it could do so by disposing of additional Fund A shares, to bring it within the 25% limitation for Corp Z. This assumes, however, that Upper RIC is aware of Fund A’s failure. Upper RIC may not become aware of the failure within the 30 day period, if Fund A is an unaffiliated fund. In any event, an upper-tier RIC should not be required to cure the diversification failure if Fund A cures, as it was Fund A’s action that created the problem.

We thus ask the IRS and Treasury Department to confirm that the upper-tier RIC will be deemed to satisfy the 25% test if the lower-tier RIC cures its failure within 30 days. One way to do so is to provide a safe harbor to the controlled group rules, pursuant to which an upper-tier RIC that invests solely in other RICs will not fail the diversification test, so long as all of the lower-tier RICs satisfy the diversification test, taking into account any cures under section 851(d).

Market Value Exception

Another technical issue could arise if a lower-tier RIC is relying upon the market value exception in the first sentence of section 851(d)(1). That exception provides that a fund that has previously satisfied the diversification test will not lose its status as a RIC merely because of changes in the values of its holdings. If the controlled group rules are applied to a fund of funds, the market value exception might not apply with respect to a specific security if (i) the upper-tier fund increases its investment in one of the lower-tier funds, even though this reduces its overall exposure to the

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8 As a technical matter, section 851(d)(1) does not provide that Fund A is treated as having no more than 25% of its assets invested in Corp Z securities at the end of the quarter. Rather, it provides simply that Fund A will not lose its status as a RIC because the failure was cured within 30 days. This could mean that Fund A’s cure does not pass through to Upper RIC.
underlying security; (ii) any of the lower-tier funds acquires additional interests in the security; or (iii) redemptions by an unrelated party in a lower-tier fund causes the upper-tier fund’s proportionate interest in the security to increase. Any of these events could jeopardize the upper-tier RIC’s status under subchapter M. This problem also can be resolved by a rule that deems the upper-tier fund to satisfy the 25% test so long as the lower-tier funds have so qualified.

**Example:** Upper RIC invests solely in other RICs that it controls within the meaning of section 851(c). It has 20% of its assets invested in each of Funds A, B, C, D, and E.\(^9\) Upper RIC and Funds A, B, C, D, and E constitute a controlled group. The percentage of assets invested in Corp Z by each of Funds A, B, C, D, and E is indicated below:

<table>
<thead>
<tr>
<th>% of Fund Assets Invested in Corp Z</th>
<th>Upper RIC Assets Invested in each Fund</th>
<th>% of Upper RIC’s Assets Invested in Corp Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund A 25%</td>
<td>x 20%</td>
<td>= 5.0%</td>
</tr>
<tr>
<td>Fund B 25%</td>
<td>x 20%</td>
<td>= 5.0%</td>
</tr>
<tr>
<td>Fund C 25%</td>
<td>x 20%</td>
<td>= 5.0%</td>
</tr>
<tr>
<td>Fund D 25%</td>
<td>x 20%</td>
<td>= 5.0%</td>
</tr>
<tr>
<td>Fund E 22%</td>
<td>x 20%</td>
<td>= 4.4%</td>
</tr>
</tbody>
</table>

Total: 24.4%

Upper RIC thus has 24.4% of its assets invested in Corp Z through the controlled group.

At the close of the quarter, the value of Corp Z stock has increased, causing the percentage of Funds A, B, C, D and E’s assets invested in Corp Z to increase to 26%, 26%, 26%, and 22.88%, respectively. As a result of the increase in the value of Corp Z, the percentage of Upper RIC’s assets invested in Corp Z increases to 25.376%.\(^{10}\) Because this increase in value is not due to an acquisition, the market value exception applies, and Upper RIC and Funds A through D do not lose their status as RICs.

Upper RIC later has increased inflows and decides to purchase additional shares of Fund A, increasing the portion of its assets invested in Fund A to 21%. The additional cash put into Fund A by Upper RIC when purchasing additional shares increases Fund A’s total net assets; therefore, the percentage of Fund A’s assets invested in Corp Z decreases. Similarly, because Upper RIC has purchased additional Fund A securities without redeeming any shares in Funds B through E, the percentage of its assets invested in Funds B through E decreases. Thus, after the additional purchase of Fund

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\(^9\) We assume for purposes of this example that all of the funds are of equal size.

\(^{10}\) For purposes of this example, we assume that all other variables remain constant.
A shares by Upper RIC, the assets invested in Corp Z through Funds A through E are as follows:

<table>
<thead>
<tr>
<th>Fund</th>
<th>% of Fund Assets Invested in Corp Z</th>
<th>Upper RIC Assets Invested in each Fund</th>
<th>% of Upper RIC’s Assets Invested in Corp Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund A</td>
<td>25.74%</td>
<td>21%</td>
<td>5.406%</td>
</tr>
<tr>
<td>Fund B</td>
<td>26%</td>
<td>19.75%</td>
<td>5.135%</td>
</tr>
<tr>
<td>Fund C</td>
<td>26%</td>
<td>19.75%</td>
<td>5.135%</td>
</tr>
<tr>
<td>Fund D</td>
<td>26%</td>
<td>19.75%</td>
<td>5.135%</td>
</tr>
<tr>
<td>Fund E</td>
<td>22.88%</td>
<td>19.75%</td>
<td>4.519%</td>
</tr>
</tbody>
</table>

Total: 25.330%

The question is whether this acquisition of additional Fund A shares by Upper RIC precludes the application of the market value exception to Upper RIC. If the market value exception no longer applies, Upper RIC would have more than 25% of its assets invested in Corp Z and thus would fail the diversification test. This could occur even though Upper RIC’s purchase of additional Fund A shares actually causes the percentage of Upper RIC’s assets invested in Corp Z to decrease, from 25.376% to 25.330%.

Alternatively, assume that after the value of Corp Z stock increases in value as described above, Fund E decides to purchase additional shares in Corp Z, increasing the portion of its assets invested in Corp Z to 24%. Even with the increase in market value, Fund E continues to satisfy the diversification test. It is unclear, however, whether this acquisition nullifies the market value exception for Upper RIC. If the exception does not apply, Upper RIC would have a total of 25.6% of its assets invested in Corp Z through the controlled group. The purchase by Fund E arguably thus could cause Upper RIC to fail the diversification test, even though Upper RIC itself has not made any additional acquisitions, and all the lower-tier RICs continue to qualify under Subchapter M.

Yet another complication could arise if the net assets of one of the lower-tier funds are reduced due to redemptions. Assume that an unrelated investor in Fund B redeems its shares after the increase in the value of Corp Z’s stock. This redemption reduces Fund B’s overall net assets, thereby increasing the percentage of its assets invested in Corp Z (assuming Corp Z stock is not distributed in the redemption or sold to generate the redemption proceeds). As a result, the redemption increases the percentage of Upper RIC’s assets invested in Corp Z through the controlled group. We believe the increased investment by Upper RIC in Corp Z through Fund B should not constitute an acquisition that could preclude the application of the market value exception, causing Upper RIC to fail the 25% test, though confirmation of this result would be welcome.

The final regulations thus should clarify how the controlled group rules interact with the market value exception in section 851(d)(1). Again, this issue should be resolved if the final regulations provide that an upper-tier fund that only holds shares of other RICs (other than cash, cash items, and
government securities) will be deemed to satisfy the diversification test if all of the underlying RICs have qualified, taking into account section 851(d).

**Upper-Tier RIC Invests in Other Assets**

The proposed regulations on controlled groups also may raise issues in the fund of funds context if the upper-tier fund invests directly in non-RIC assets (other than cash, cash items, and government securities), as well as in other RICs. An upper-tier fund may have a portion of its assets invested in securities of a particular issuer that also are held by one or more lower-tier funds. Alternatively, an upper-tier RIC could invest in other non-RIC entities, such as other '40 Act funds, that invest in issuers that also are held by the lower-tier RICs. These types of situations could arise for a number of reasons. For example, we understand that many portfolio managers at the upper-tier may invest directly to provide more control over their investments. We also understand that in many contexts there may be limited issuers, such as in single-country, single-industry, or single-state municipal bond funds. Issues also could arise if the upper-tier or lower-tier fund invests in derivatives, the issuers of which overlap with other derivatives or direct investments made by the other fund.

Many of the same issues that may arise when a RIC invests solely in other RICs also may occur in this context. As discussed above, the upper-tier RIC could have a different quarter-end than the lower-tier RICs. This could cause the upper-tier RIC to fail the 25% test if the lower-tier RIC’s investment in a single issuer exceeds 25% of its assets prior to the lower-tier RIC’s quarter-end. Also, it is unclear whether a cure under section 851(d) by a lower-tier RIC applies to the upper-tier RIC. If the upper-tier fund and the lower-tier fund are unaffiliated, the upper-tier fund may not know until sometime after the end of its quarter which investments made by the lower-tier fund could be problematic. The application of the controlled group rules in conjunction with the market value exception in section 851(d)(1) also raises concerns, as illustrated by the example above.

The IRS and Treasury Department could resolve these issues by providing a safe harbor under the controlled group rules for a fund of funds that invests in other RICs plus other assets, provided that (i) the lower-tier RICs have satisfied the 25% test, and (ii) the upper-tier RIC’s other investments in a single issuer are not more than 25% of its total assets, other than securities of other RICs. If these two conditions are satisfied, the upper-tier RIC should not have more than 25% of its aggregate assets invested in a single issuer. Providing a safe harbor for these limited circumstances will reduce the burden on funds and help ensure that a RIC does not inadvertently fail the diversification test.

**Variable Insurance Products**

The application of the controlled group rules to a fund of funds also could have implications for variable insurance products. A segregated asset account may satisfy the diversification test of section 817(h) by investing in a single RIC. That RIC would hold an investment portfolio, which could include other RICs. Provided that the upper-tier fund qualifies as a RIC and certain other requirements are satisfied, the segregated asset account generally may look through the RIC to its
underlying assets to satisfy the section 817(h) test. If the controlled group rules cause the upper-tier fund to lose its status as a RIC for one or more of the reasons described above, then the segregated asset account may not look through the fund to its underlying investments. Because it would be invested solely in one issuer (the upper-tier fund), it would fail the diversification test in section 817(h). The consequences of this failure could be particularly dire, as the contract holders might have to include currently any income from the variable insurance fund.

Resolution Needed

The potential for these issues to arise will require funds to more closely monitor investments in fund of funds structures. Though funds will put controls in place to ensure compliance, the upper-tier fund will need to watch closely investments at the lower-tier levels to make certain that the upper-tier fund does not inadvertently fail the 25% diversification test. These problems are exacerbated if the lower-tier funds are unaffiliated with the upper-tier fund. If the funds are unaffiliated, there will be less transparency as to the underlying investments, and the upper-tier fund will have no ability to control investment decisions at the lower-tier level. All of this coordination and testing will be resource-intensive. Given that an investor in the upper-tier fund could invest in all of the lower-tier funds directly, but for the convenience and efficiencies offered by the fund of funds structure, it is not clear that this additional work is necessary or beneficial. Therefore, it is crucial that the IRS and Treasury Department resolve these issues.

The final regulations thus should clarify how the controlled group rules apply in the context of a fund of funds. All of these issues should be resolved if the final regulations provide that an upper-tier RIC will satisfy the 25% diversification test, if (i) the lower-tier RICs have satisfied the 25% test, including by reason of section 851(d), and (ii) its investment in any one issuer (not including any indirect investment through a lower-tier RIC) does not exceed 25% of its total assets, excluding its investments in other RICs.

Aggregate Limit on Investment in QPTPs

The proposed regulations would add a new example 7 to Treas. Reg. § 1.851-5 to illustrate the application of the controlled group rules in the context of the 25% limitation in section 851(b)(3)(B)(iii) on a RIC’s investment in QPTPs. The Institute believes that the controlled group rules should not apply to the QPTP limitation to the extent that the RIC’s indirect investment in QPTPs is through one or more taxable corporations.

To provide QPTPs with improved access to the capital markets, Congress added net income from an interest in a QPTP to the definition of “good income” under section 851(b) in 2004. Congress enacted the 25% limitation on investment in QPTPs at the same time. The limitation on a RIC’s aggregate investments in QPTPs is different in principle from the two issuer-focused limitations, as it is not specific to a particular issuer, and it does not include any control or related-business requirement. As explained in the legislative history, the purpose of the 25% QPTP limitation was to prevent tax-
exempt entities and foreign investors from avoiding unrelated business taxable income ("UBTI") and effectively connected income ("ECI"), respectively, that would arise if those entities invested directly in MLPs. Without this rule, a RIC effectively could “block” the MLP income from generating UBTI or ECI for those investors.

As others have commented, the purpose of the 25% limitation on QPTPs is satisfied if a RIC invests in MLPs through a fully taxable corporation. The corporation pays tax on income derived from the MLPs and thus prevents the tax avoidance by tax-exempt entities and foreign investors about which Congress was concerned. Therefore, the controlled group rule adds an unnecessary restriction on a RIC’s ability to invest in QPTPs. It is important to note that the RIC still is subject to the other diversification requirements under section 851(b)(3), which provides other limits on its ability to invest in QPTPs.

We acknowledge that the purposes of the 25% limitation may not be satisfied if the underlying subsidiary also is a RIC that invests in MLPs. The lower-tier RIC also would be subject to the 25% limitation, however, thereby reducing the total exposure to MLPs that would be available to the upper-tier RIC’s investors. If the underlying RIC satisfies the 25% diversification test with respect to MLPs, then the upper-tier RIC cannot have more than 25% of its assets invested in MLPs through the lower-tier RIC, regardless of the percentage of its assets invested in the lower-tier RIC.

The Institute thus asks the IRS and the Treasury Department to exercise their explicit regulatory authority under section 851(c)(1) to limit the application of the controlled group rules. Given the purpose of the 25% limitation on investment in QPTPs, we do not believe the controlled group rules should apply to the extent that a RIC invests in QPTPs through one or more taxable corporations.

Amend Treas. Reg. § 1.851-3

Finally, we echo the comments of others and suggest that the IRS and Treasury Department clarify the application of the controlled group rules by amending Treas. Reg. § 1.851-3. We agree that providing specific regulatory language articulating key aspects of the rules would provide more clarity than simply revising the examples in Treas. Reg. § 1.851-5. This is particularly true given the issues raised by the proposed regulations for fund of funds structures. Additional regulations will be needed to address those concerns, as they cannot be resolved through examples. We thus ask the IRS and

12 Section 851(c)(1) provides:

In ascertaining the value of the taxpayer’s investment in the securities of an issuer, for the purposes of [section 851(b)(3)(B)], there shall be included its proper proportion of the investment of any other corporation, a member of a controlled group, in the securities of such issuer, as determined under regulations prescribed by the Secretary(emphasis added).
Treasury Department to clarify the controlled group rules, and address the issues and suggestions we have made here, by amending Treas. Reg. § 1.851-3.

* * *

Thank you for considering the Institute's concerns. We look forward to discussing these comments with you. In the meantime, if you have any questions, please contact me at (202) 371-5432 or kgibian@ici.org.

Sincerely,

/s/ Karen L. Gibian

Karen Lau Gibian
Associate Counsel – Tax Law

cc: Susan Baker
    Julanne Allen