

MEMO# 27650

October 24, 2013

Draft Letter on Controlled Group Proposed Regulations -- Comments Requested

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TO: TAX COMMITTEE No. 31-13 RE: DRAFT LETTER ON CONTROLLED GROUP PROPOSED
REGULATIONS -- COMMENTS REQUESTED

Attached for your review is a draft letter providing comments on the recently proposed regulations under section 851(c) regarding the application of the controlled group rules to the 25% asset diversification test. [\[1\]](#) The Institute believes that the proposed regulations could have unintended consequences for fund of funds structures, both where the upper-tier regulated investment company ("RIC") invests solely in other RICs (other than assets used for cash management purposes), and where the upper-tier RIC invests directly in other assets, in addition to the securities of other RICs.

The application of the controlled group rules to a fund of funds could cause the upper-tier fund to fail inadvertently the 25% diversification test. This may occur if the upper-tier and lower-tier funds have different quarter ends; if a lower-tier fund fails the diversification test but then later cures the failure under section 851(d)(1); or if one or more of the lower-tier funds are relying upon the market value exception in section 851(d)(1).; To resolve these issues, the Institute recommends that the Internal Revenue Service ("IRS") and the Treasury Department provide a safe harbor for upper-tier funds. Pursuant to this safe harbor, an upper-tier RIC in a fund of funds will satisfy the 25% test, provided that (i) all of the lower-tier RICs satisfy the asset diversification test, including 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 does not exceed 25% of its total non-RIC assets.

The Institute also asks the IRS and the Treasury Department to exercise their 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, the Institute believes the controlled group rules should not apply to the extent that a RIC invests in QPTPs through one or more taxable corporations.

Finally, the Institute recommends that the IRS and the Treasury Department clarify the application of the controlled group rules by amending Treas. Reg. § 1.851-3, rather than

simply modifying the examples in Treas. Reg. § 1.851-5.

The final comments must be submitted to the IRS and the Treasury Department on Thursday, October 31, 2013. Therefore, please provide any comments on the attached letter to me (kgibian@ici.org or 202/371-5432) no later than the close of business on Wednesday, October 30, 2013. We also will discuss the draft letter at the Tax Committee meeting next week.

Karen Lau Gibian
Associate Counsel

[Attachment](#)

endnotes

[1] See Institute Memorandum ([27432](#)) dated August 1, 2013.;

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