INVESTMENT COMPANY INSTITUTE

**MEMO# 6389**

November 16, 1994

# IRS REVENUE PROCEDURE ON RIC INVESTMENTS IN PARTNERSHIPS

* See Institute Memoranda to Accounting/Treasurers Members No. 18-94, Closed-End Fund Committee No. 17-94 and Tax Members No. 28-94, dated June 21, 1994; and to Accounting/Treasurers Members No. 15-94, Closed-End Fund Committee No. 14-94 and Tax Members No. 25-94, dated June 10, 1994. November 16, 1994 TO: ACCOUNTING/TREASURERS MEMBERS NO. 36-94 CLOSED-END FUND COMMITTEE NO. 26-94 TAX MEMBERS NO. 47-94 RE: IRS REVENUE PROCEDURE ON RIC INVESTMENTS IN PARTNERSHIPS ______________________________________________________________ As we previously informed you, in June the IRS issued Revenue Ruling 94-40, which requires that a regulated investment company ("RIC") be treated as receiving its share of the income of any partnership in which it invests -- for purposes of the minimum distribution excise tax rules of Internal Revenue Code section 4982 -- on the date such income is taken into account by the partnership.* The attached revenue procedure (Rev. Proc. 94- 71) describes the circumstances under which the IRS will not challenge the use by a RIC of an accounting method that fails to comply with Rev. Rul. 94-40. This revenue procedure, like Rev. Rul. 94-40, is effective for excise tax years ending on or after December 31, 1994. Under Rev. Proc. 94-71, the IRS will not challenge a RIC's consistent use of an accounting method that fails to comply with Rev. Rul. 94-40 if three conditions are met. In determining "consistent use", the IRS will apply the revenue procedure on a partnership-by-partnership basis. Thus, a RIC may apply (or be required to apply) Rev. Rul. 94-40 to its interests in one or more of its partnership investments and not to its other partnership investments. The effect of Rev. Proc. 94-71 is to require a RIC to apply Rev. Rul. 94-40 in the following two scenarios. First, Rev. Rul. 94-40 must be applied for the calendar year to all of a RIC's partnership interests if the RIC fails a "35 percent asset test" on any "testing date" during the calendar year (and the failure is not "cured" within 30 days). Under this asset test, the RIC must have less than 35 percent of its assets invested in partnerships on each "testing date" during the calendar year. In general, the testing dates are a RIC's fiscal quarter-ends. However, the RIC may elect to consistently use as its testing dates January 31, April 30, July 31 and October 31. In determining whether a RIC fails the asset test, the revenue procedure states that the principles of Code section 851(d) (that apply for diversification test purposes) shall apply. Thus, for example, a RIC would have 30 days following the testing date to "cure" an asset test failure by restructuring its portfolio to reduce its partnership holdings to less than 35 percent of its assets. Second, the revenue procedure requires that Rev. Rul. 94-40 be applied for the calendar year to a specific partnership interest if, at any time during the 12-month period ending on the last testing date during the calendar year, the RIC holds 50 percent or more of the profits and capital interests of the partnership. The revenue procedure also provides guidance for situations in which a RIC changes the way it takes any partnership item into account for excise tax purposes, such as because the RIC fails to

satisfy the 35 percent asset test or the RIC's interest in a partnership increases to 50 percent or more during the year. Specifically, the revenue procedure requires that the RIC take into account -- as of the first day of the calendar year of change -- any adjustments that are necessary to prevent the change from cauing an omission or duplication of any partnership item. We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment

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