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***By Electronic Delivery***

October 24, 2016

Hon. William Wilkins  
Chief Counsel  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Tom West  
Tax Legislative Counsel  
U.S. Department of the Treasury  
1500 Pennsylvania Avenue, NW  
Washington, DC 20220

RE: Notice 2016-23: Request for Comments  
Regarding Implementation of the New  
Partnership Audit Regime

Dear Mr. Wilkins and Mr. West:

The Investment Company Institute<sup>1</sup> urges the Internal Revenue Service (“IRS”) and the Treasury Department to clarify application of the new partnership audit regime, enacted as part of the Bipartisan Budget Act of 2015, to regulated investment companies (“RICs”) that are partners in an audited partnership. Specifically, the Institute agrees with the National Association of Real Estate Investment Trusts (“NAREIT”) that the deficiency dividend procedures under section 860 should be available.<sup>2</sup> Like real estate investment trusts (“REITs”), RICs often invest in partnerships and thus may become subject to the new partnership audit procedures as a partner in a partnership that is subject to audit. We thus ask the IRS and the Treasury Department to confirm that RICs may use the existing deficiency dividend procedures with respect to their allocable share of the applicable adjustment to partnership income, gain, loss, or deduction, and take any deficiency dividend paid into account in (1) the filing of a return by a RIC in accordance with new section 6225(c); or, (2) the calculation of the RIC’s adjustment to tax under new section 6226(b). We also ask the government to clarify the application of the interest and penalties under the new partnership audit rules and section 860.

**RIC Investments in Partnerships**

RICs often own equity interests in partnerships. Most commonly, they own small passive equity interests in publicly traded partnerships (“PTPs”) as portfolio investments. In addition, fund complexes sometimes form partnerships as internal vehicles in which multiple RICs can

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<sup>1</sup> The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s U.S. fund members manage total assets of \$18.5 trillion and serve more than 90 million U.S. shareholders.

<sup>2</sup> See Letter from Tony M. Edwards, Executive Vice President and General Counsel, NAREIT, dated April 15, 2016.

invest, to collectivize the management of investments in a particular sector or strategy across multiple RICs and to achieve economies of scale and other efficiencies. Some RICs also may invest in non-publicly traded external partnerships (e.g., private equity funds or portfolio companies organized as partnerships).

RICs are permitted to invest in these various types of partnerships so long as they do so in accordance with the RIC qualification requirements of Subchapter M. Generally, section 852 requires a RIC to generate at least 90% of its income from certain qualifying sources and to satisfy asset diversification requirements. In general, these rules provide that income derived from a partnership is treated as qualifying income only to the extent that the income is attributable to items of income of the partnership that would be qualifying income if realized by the RIC directly. In other words, the RIC generally looks through the partnership for RIC qualification purposes.

This look-through rule does not apply, however, to income from qualified publicly traded partnerships (“QPTPs”). A QPTP is any partnership eligible to be treated as a partnership, notwithstanding that interests in it are traded on an established securities market or readily tradable on a secondary market, if at least 90 percent of its income derives from the passive income sources set forth in section 7704(d). A PTP, however, that derives 90 percent of its income from sources that would be qualifying income for purposes of Subchapter M (i.e., interest, dividends, capital gains, etc.) is not a QPTP.<sup>3</sup> All net income from QPTPs is qualifying income for RICs, but a RIC is prohibited from investing more than 25% of the value of its total assets in the securities of QPTPs.<sup>4</sup> Thus, under the rules in Subchapter M, a RIC can invest: (i) in QPTPs, but only up to 25% of its net assets; (ii) in publicly traded partnerships other than QPTPs without a specific partnership-related limitation;<sup>5</sup> and (iii) in non-publicly traded partnerships, provided that the income passed through will not cause the RIC to fail its qualifying income requirements.

RICs thus have significant flexibility to invest in partnerships and frequently do so. As noted above, they often invest in PTPs such as “master limited partnerships” (“MLPs”) that engage in oil and gas and other natural resource-related businesses. These MLPs typically are quite large with hundreds of investors. A RIC evaluates these investments in much the same way that it would a small passive equity investment in the stock of a corporation. As part of a fund’s general investment strategy, and like any other equity investment, the RIC may hold the MLP interest for several years or for a shorter term. When a RIC acquires an MLP interest on an exchange, it is deemed to agree to the MLP’s partnership agreement, which is publicly available. As a current or former partner in an MLP or any other partnership in which it invests, a RIC could be subject to the new partnership audit rules if the partnership is audited by the IRS.

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<sup>3</sup> Sec. 851(h); sec. 7704(e)(3).

<sup>4</sup> Sec. 851(b)(3)(B)(ii).

<sup>5</sup> This is because at least 90% of such a PTP’s income will be, by definition, from qualifying RIC sources or the PTP will be taxed as a corporation.

### **Deficiency Dividend Procedures**

In addition to the gross income and asset tests set forth in section 851(b), a RIC must satisfy certain distribution requirements to avoid federal income tax at the entity level. Mechanically, the RIC receives a dividends paid deduction for any distributions made to shareholders, which can be used to offset the RIC's income and prevent taxation at the RIC-level. Generally, section 852(a) requires a RIC to distribute at least 90 percent of its income and gains for its fiscal year. Any amount retained by the RIC above the 90 percent will be subject to a RIC-level tax because the RIC has not generated a dividends paid deduction to offset that income. Additionally, RICs are subject to a 4 percent excise tax under section 4982 if they do not distribute 98 percent of their ordinary income and 98.2 percent of their capital gains (measured through October 31) for the calendar year, plus any amounts not distributed in the prior calendar year. As a result of these two distribution requirements, RICs generally distribute substantially all of their income and gains annually.

If it later is determined that a RIC has distributed less than all of its income for a taxable year (and is unable to pay a spillback dividend under section 855 for that year), it still can avoid RIC-level tax on the undistributed income, and prevent any failure to satisfy its 90% distribution requirement for that year, by paying a deficiency dividend under Section 860. A deficiency dividend is deductible in the year to which it relates regardless of when it is actually paid. A RIC-level interest charge applies, however, and accrues on the full amount of the deficiency dividend, rather than just the tax that would be owed. A deficiency dividend can only be made after a "determination" of an adjustment is made.

A determination can be: (1) a final decision or judgment by the Tax Court or other court with jurisdiction; (2) a closing agreement; (3) an agreement between the Secretary of the Treasury and the RIC; or (4) a self-determination by the RIC, detailed in a statement attached to its amendment or supplement to its tax return for the relevant tax year.<sup>6</sup> The adjustment, in the case of a RIC, generally is: (i) an increase in the RIC's investment company taxable income, determined without regard to the deduction for dividends paid; (ii) an increase in the amount of net capital gain that exceeds the deduction for capital gain dividends paid; or (iii) a decrease in the deduction for dividends paid, without regard to capital gain dividends.<sup>7</sup>

If such a determination is made, a RIC may pay a "deficiency dividend" to its shareholders within 90 days after the date of the determination.<sup>8</sup> It also must file a claim with the IRS for a deduction for the deficiency dividend within 120 days of the determination.<sup>9</sup> It then may include a deduction equal to the amount of the deficiency dividend for purposes of calculating the dividends paid deduction for the adjusted tax year.<sup>10</sup> The amount of the

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<sup>6</sup> Sec. 860(e).

<sup>7</sup> Sec. 860(d)(1).

<sup>8</sup> Sec. 860(f)(1).

<sup>9</sup> Sec. 860(g).

<sup>10</sup> Sec. 860(a).

deficiency dividend paid is treated as an additional tax on the RIC for purposes of determining the amount of interest due such that (as noted above) interest accrues on the full amount of the deficiency dividend.<sup>11</sup> The interest due is calculated from the last date on which the RIC could have paid tax for the taxable year for which the determination is made to the date the claim for deficiency is filed with the IRS.<sup>12</sup>

The deficiency dividend procedures thus allow a RIC that is subject to an adjustment to avoid a RIC-level tax on any undistributed income and cure any related failure to satisfy the 90% distribution requirement, albeit at the cost of an interest charge on the amount of the deficiency dividend.

### **Application of Partnership Audit Rules to RICs**

As discussed above, RICs often invest in MLPs or other partnerships and thus may be subject to adjustments resulting from an audit of a partnership in which they invest or have invested previously. Under the new partnership audit rules, such an adjustment could affect a RIC's distribution requirements for a prior year or years. As the Joint Committee on Taxation has noted, Congress intended for the deficiency dividend rules under section 860 to be available for RICs and REITs that are partners in partnerships subject to the new audit rules.<sup>13</sup> We thus urge the Treasury Department and the IRS to clarify how section 860 applies in the context of sections 6225 and 6226 to ensure that the procedures work smoothly. We also recommend that the government (i) specify the "determination date" for purposes of section 860 when a partnership is audited; (ii) confirm that a RIC that pays a deficiency dividend will be charged interest only under section 860; (iii) provide that a RIC or other partner will be subject to penalties only to the extent that it has any tax liability under section 6226 resulting from its share of an adjustment under that provision; and (iv) permit tiered partnerships to use the alternative audit procedures under section 6226.

#### *Availability of Deficiency Dividend Procedures*

Under new section 6225, a partnership's imputed underpayment amount may be reduced by taking into account the impact of the underlying adjustments on the partners' reviewed year returns. A RIC that is a partner thus could amend the reviewed year return to reflect the new amount of income allocable to it and pay any tax due.

If the partnership chooses to apply the rules under section 6225, and the RIC plans to amend the reviewed year return to reflect its allocable share of the adjustment, the RIC clearly should be able to treat a determination as having occurred under section 860. It thus should be able to choose whether to pay a deficiency dividend in respect of the adjustment to generate a dividends paid deduction that can be taken into account on the reviewed year return to avoid any

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<sup>11</sup> Sec. 860(c)(1).

<sup>12</sup> *Id.*

<sup>13</sup> See General Explanation of Tax Legislation Enacted in 2015 (the "Blue Book"), Joint Committee on Taxation, March 2016, p. 70.

RIC-level tax (other than the interest charge that would arise under the deficiency dividend procedures). Payment of the deficiency dividend should satisfy the requirement that the partner pay any tax due when filing the amended return. This seems to be well within the spirit and the letter of the deficiency dividend rules.

Alternatively, new section 6226 provides procedures under which a partnership may send adjusted partnership statements to the partners for the reviewed year. Those partners would include in their adjustment year tax return an amount determined by calculating the amount by which their tax liability would have increased in the reviewed year, and any subsequent years, if that partner's allocable share of the adjustments had been properly taken into account in the reviewed year.

If the partnership chooses to apply the alternate audit procedures under section 6226, and a RIC receives an adjusted partnership statement reporting the RIC's share of the adjustment for the reviewed year, the deficiency dividend procedures also should be available to the RIC. Section 6226 requires the partner to calculate the amount by which its tax liability would have increased in the reviewed year, and any subsequent years, if the partner's allocable share of the adjustments had been properly taken into account in the reviewed year.

In the RIC context, when the RIC calculates the amount by which its tax liability would have increased in the reviewed year if its share of the adjustments had properly been taken into account, the inclusion of the adjustment may cause the RIC's adjusted net income/gains for the reviewed year or subsequent years<sup>14</sup> to exceed its actual dividends paid deductions for those years. This is because the RIC did not make a distribution in respect of that (then unknown) amount, and the increase to tax liability may be a RIC-level tax on some or all of the adjustment (plus interest). Moreover, the adjustment possibly could cause the RIC's actual distributions for that year to be less than 90% of its net income, resulting in an increase to tax liability equal to a corporate-level tax on all of the RIC's income for that year (plus interest). As noted above, the deficiency dividend procedures of section 860 were enacted to address exactly these types of issues by allowing a RIC to pay a current distribution of late-determined income or gains (and interest), generating a dividends paid deduction for the year to which this income or gain relates to avoid a RIC-level tax for that year.

As discussed in the Blue Book, Congress expected the Secretary to issue guidance permitting the use of the deficiency dividend procedures by RICs and REITs that are partners in a partnership audited under these new rules.<sup>15</sup> Specifically, the Blue Book states:

A recipient partner that is a RIC or a REIT and that receives a statement from an audited partnership including adjustments for a prior (reviewed) year may wish to make a deficiency dividend with respect to the reviewed year. Guidance

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<sup>14</sup> An adjustment that increases the RIC's allocation of net income/gain or decreases the RIC's allocation of net losses/deductions from the partnership could increase the RIC's net income/gain and potential tax liability for the current year. It also could reduce the amount of the net losses (or dividends paid deductions) that otherwise would be carried into the RIC's subsequent year, thereby impacting the potential tax liability for subsequent years.

<sup>15</sup> See Blue Book, p. 70.

coordinating receipt of a statement from an audited partnership by a RIC or REIT with the deficiency dividend procedures is expected to be issued by the Secretary.<sup>16</sup>

We thus ask the IRS and the Treasury Department to confirm that a RIC that is a partner in a partnership subject to the new audit procedures may use the existing deficiency dividend procedures under section 860.

*Date of Determination under Sec. 860*

We also recommend that the determination date under section 860 begin no earlier than when the RIC receives a partnership statement with adjustment amounts. As discussed above, the determination date begins the 90-day period during which a RIC can make a deficiency dividend.<sup>17</sup> A determination can be: (1) a final decision or judgment by the Tax Court or other court with jurisdiction; (2) a closing agreement; (3) an agreement between the Secretary of the Treasury and the RIC; or (4) a self-determination by the RIC, detailed in a statement attached to its amendment or supplement to its tax return for the relevant tax year.<sup>18</sup>

Without further clarification, a court decision or other event at the partnership level that affects the partnership's tax liability could be viewed as a determination event under section 860. We do not believe that this would be appropriate, because the RIC might not have knowledge of that event; even if the RIC did know about the event, it likely would not have the information necessary to determine whether a deficiency dividend is required and, if so, how much must be distributed. Thus, a determination should not occur under section 860 any earlier than when the RIC is notified of an adjustment by the partnership.

*Interest*

We also ask the Treasury Department and the IRS to confirm that if a RIC pays a deficiency dividend with respect to its allocable share of an applicable adjustment to partnership income, gain, loss, or deduction, it only will be assessed an interest charge under the deficiency dividend rules. In doing so, the government would confirm that the interest surcharge imposed under section 6226 would not apply, thus preventing the imposition of double interest.

Under section 6226, interest is determined at the partner level by taking into account any increases attributable to a change in tax for an affected taxable year, equal to the sum of the Federal short-term rate plus 5 percentage points.<sup>19</sup> As noted above, section 860 imposes interest on the full amount of a deficiency dividend paid by a RIC, rather than on the additional amount of tax due. It would be inappropriate to apply both interest charges to a RIC, particularly given that other non-RIC partners in the partnership would not be subject to double interest. The interest

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<sup>16</sup> *Id.*

<sup>17</sup> Sec. 860(f)(1).

<sup>18</sup> Sec. 860(e).

<sup>19</sup> Sec. 6226(c)(2).

charged under section 6226 should apply only if the partner has any tax liability with respect to the reviewed year. Because a RIC that utilizes the deficiency dividend procedures under section 860 would not have any tax liability for the reviewed year, it only should be subject to interest under section 860.<sup>20</sup> This would prevent the imposition of double interest.

### *Penalties*

Although interest under section 6226 is determined at the partner level, any penalties or additions to tax are computed at the partnership level; each partner for the reviewed year is then liable for its share of the penalties.<sup>21</sup> The statute does not specify, however, how such penalties are allocated among the partners. If a partner's share of the reviewed year adjustment does not result in any additional tax liability for that partner, the partner should not be subject to any portion of the penalties assessed at the partnership level. This is particularly true if a RIC pays a deficiency dividend for the reviewed year and therefore has no additional tax liability. The deficiency dividend procedures under section 860 are designed to permit RICs to pay a distribution in the current year to avoid any tax liability and penalties for any late-discovered income.<sup>22</sup> Therefore, we recommend that a partner should be allocated a share of penalties assessed under section 6226 at the partnership level only to the extent that the partner has any tax liability under section 6226.

### *Tiered Partnerships*

Finally, the Institute agrees with others who have recommended the ability of an upper-tier partnership to pass through to its partners an adjustment from a lower-tier partner under section 6226. We believe that such a rule satisfies the intent of the new partnership audit rules without unfairly harming lower-tier partners by denying them the benefits of the alternative rules in section 6226.

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<sup>20</sup> We note that the interest charged under section 860 likely will be higher than that imposed under section 6226.

<sup>21</sup> Sec. 6226(c)(1).

<sup>22</sup> As discussed above, RICs that pay deficiency dividends still are subject to an interest charge under section 860.

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The Institute and its members appreciate your consideration of our recommendations. Please feel free to contact me (202-371-5432 or [kgibian@ici.org](mailto:kgibian@ici.org)) if you would like to discuss them further.

Sincerely,

*/s/ Karen L. Gibian*

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