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***By Electronic Delivery***

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RE: RICs and Section 355 Active Trade or Business Requirement

Dear Mr. Vallabhaneni and Mr. Wellen:

The Investment Company Institute[1] requests guidance regarding the applicability of section 355 to regulated investment companies (RICs). Specifically, we ask the Treasury Department and the Internal Revenue Service (IRS) to clarify that RICs can satisfy the "active trade or business requirement" under section 355(b)(1) with respect to their business of investing in securities. Given the current tax treatment of RICs and the nature of their business, we believe that this rule should not prevent RICs from otherwise satisfying the requirements for a tax-free split-off.[2] We understand that the Treasury Department and the IRS are re-evaluating the current regulations under section 355 and thus ask the government to clarify that RICs can satisfy the active trade or business requirement with respect to their business of investment management.

**Background**

While all RICs are corporations for Federal income tax purposes, they also are subject to special rules under Subchapter M of the Internal Revenue Code. Application of the rules in Subchapter C to RICs sometimes unintentionally limits the benefits that Subchapter M provides investors, by allowing the tax consequences, rather than legitimate non-tax business reasons,

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[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. Its members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in Europe, Asia and other jurisdictions. Its members manage total assets of $31.0 trillion in the United States, serving more than 100 million investors, and an additional $10.0 trillion in assets outside the United States. ICI has offices in Washington, DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

[2] For a comprehensive discussion of how RICs operate and why RICs should be treated as engaged in an active trade or business under current law, *see* Fisher, Stephen D., "RIC-ity Split: Can a Mutual Fund Separate on a Tax-Free Basis?", Tax Notes, January 5, 2015, p. 87.

dictate the forms of corporate actions RICS may take. One such example involves the rules regarding corporate reorganizations.

*RICs' Business of Investing*

RICs, which are quite different from traditional operating companies, are pooled vehicles that provide diversified investments to retail and institutional investors. RICs are highly regulated under the Investment Company Act of 1940 (the 1940 Act), which governs the structure and operations of investment companies through a combination of registration and disclosure requirements and restrictions on day-to-day operations. Among other things, the 1940 Act addresses capital structures, custody of assets, investment activities, and the duties of fund boards. The fund industry also is subject to the Investment Advisors Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933.

There are four main types of RICs: mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs).[3] Most RICs are mutual funds, both in terms of number of funds and assets under management. Although there are some differences in the structure of the different types of RICs and how the RIC shares are created and traded, the main business of the fund types is the same.

RICs have officers and directors (if organized under state law as corporations) or trustees (if organized under state law as business trusts) who represent the interests of the funds' shareholders. Unlike operating companies, RICs typically are externally managed and do not have employees in the traditional sense. Instead, RICs rely upon third parties or service providers (either organizations affiliated with a RIC's investment adviser or independent contractors) to invest fund assets and carry out other business activities. The RICs' boards oversee the management and operations of the funds, including any contractual arrangements with service providers.

A RIC's adviser has overall responsibility for directing the fund's investments and handling its business affairs. Investment professionals employed by the adviser work on behalf of the RIC shareholders and are subject to numerous standards and legal restrictions. The adviser also often serves as the RIC's administrator, handling the fund's "back-office" functions, such as data processing, bookkeeping and internal auditing, and preparing and filing SEC, tax, shareholder, and other reports.

RICs use transfer agents to maintain records of shareholder accounts, calculate and distribute dividends and capital gains, and prepare and mail shareholder account statements, federal income tax information, and other shareholder notices. Most RICs use unaffiliated transfer agents, though some investment advisers have internal transfer agents.

Although they do not have employees, RICs are required by law to have written compliance policies and procedures that govern the operations of the fund and the fund's administrator, investment adviser, and transfer agent. These policies must be designed to ensure

[3] For more information on the types of funds, how they operate, and how they are regulated, *see* ICI 2021 Investment Company Fact Book, Appendix A, which can be found at: https://www.icifactbook.org/.

the RIC's compliance with federal securities laws. All RICs also must have a chief compliance officer (CCO) who oversees compliance with these policies and procedures. The CCO must be approved by the fund board and must produce annually a report for the board regarding the fund's compliance policies and procedures, the effectiveness of their implementation, and any material compliance matters that may have arisen.

*RIC Divisions*

Fund complexes offer a range of products to meet their investors' needs. Importantly, the suite of products must be dynamic to accommodate changes in those needs and in the marketplace. Tax consequences, however, can inhibit funds from making changes that would provide non-tax benefits to investors.

There are various reasons why a RIC may wish to reorganize under section 355. The most common purpose for dividing a RIC is to separate two or more distinct types of investors. When advisers initially sponsor a fund, it may make sense to combine all investors together to achieve economies of scale. As the RIC grows, however, that structure may be less efficient. The adviser to a fund with both institutional and retail investor classes may conclude that the investors would be better served by being in separate funds rather than in separate classes of the same fund. Funds also may wish to separate taxable and tax-exempt shareholders (such as retirement plans). RICs with co-mingled investment strategies also may decide to separate two or more sleeves of investments. Finally, an adviser may wish to eliminate a sub-fund layer in a fund-of-funds structure.

Before a RIC can reorganize, it first must seek approval from its independent board of directors/trustees. Once the board has approved a corporate division, the fund may seek a vote of its shareholders, though it is not always required to do so (particularly if the new fund essentially is a "clone" of the original).[4]

RICs have many business reasons for splitting off assets into a new fund, particularly in an ever changing and constantly growing marketplace. A RIC's ability to do so, however, is limited if the reorganization will result in taxable income to shareholders. Notably, the RIC's board would have to choose which category of investors would bear the burden of a taxable event resulting from a reorganization, and boards generally will not approve transactions if there could be an adverse tax impact to a group of shareholders. This greatly inhibits a RIC's choices for reorganizing to better serve its shareholders for non-tax reasons.

[4] *See* Rule 17a-8 of the 1940 Act; SEC Release No. IC-25666; File No. S7-21-01, July 26, 2002, which can be found at: https://www.sec.gov/rules/final/ic-25666.htm#mergers (setting forth conditions under which a shareholder vote may be required for a merger of affiliated funds). The term "merger" as used in rule 17a-8 is broader than that in the tax context and refers to a merger, consolidation, or purchase or sale of substantially all of an entity's assets, including situations in which: (i) one fund purchases the portfolio assets of the other; (ii) one fund purchases all securities issued by the other; or (iii) securities issued by one fund are exchanged for all or substantially all of the portfolio assets of the other fund. SEC Release No. IC-25666, footnote 5.

*Taxation of RICs*

One of the benefits of a RIC as an investment vehicle is that it pays little or no tax at the corporate level if it satisfies the qualification tests under section 851 and the distribution requirements under section 852. All tax, instead, is paid at the investor level and provides fund investors with tax treatment comparable to that of direct investors in securities. Mechanically, RICs receive a dividends paid deduction (DPD) under section 561 for any dividend distributions made to shareholders. Section 852(a) requires a RIC to distribute at least 90 percent of its income and gains for its fiscal year, generating a DPD for those amounts, to qualify as a RIC under Subchapter M. Any amount retained by the RIC above the 90 percent will be subject to a RIC-level tax.

Additionally, RICs are subject to a 4 percent excise tax under section 4982 if they do not distribute annually 98 percent of their ordinary income (measured on a calendar year basis) and 98.2 percent of their capital gains (measured through October 31), plus any amounts not distributed in the prior calendar year. Because of the Subchapter M and excise tax distribution requirements, RICs generally distribute substantially all their income and gains each year.

**Section 355 Requirements and Application to RICs**

Section 368 defines corporate reorganizations that may qualify for tax-free treatment. A divisive "D reorganization" under section 368(a)(1)(D) involves the transfer of assets by a corporation to a new controlled corporation if, as part of the plan, shares of the controlled corporation are distributed in a transaction that qualifies under section 354, 355, or 356. A RIC that wishes to avail itself of these provisions would contribute assets to a new RIC in exchange for all the shares of the new RIC; it then would distribute those shares to a group of its shareholders in complete redemption of their stock.[5]

Section 355 provides that the distribution of the controlled corporation stock will not result in taxable gain or loss to the receiving shareholders if certain statutory requirements are satisfied. Specifically, these requirements are: (1) a corporation distributes to shareholders with respect to its stock the stock or securities of a corporation that it controls immediately before the distribution; (2) the transaction is not used principally as a device for the distribution of earnings and profits of either or both corporations; (3) the distributing and controlled corporations are engaged in an active trade or business; (4) the distributing corporation distributes all the stock of the controlled corporation that it held immediately before the distribution; (5) there is a valid business purpose for the distribution; (6) there is a continuity of interest in each of the corporations after the division; and (7) the distributing and controlled corporations continue the operations of the business or businesses that existed before the separation.

This letter focuses on the active trade or business requirement because RICs generally should be able to satisfy the other statutory requirements in section 355. The Treasury

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[5] If sections 368 and 355 do not apply, the contribution of assets to the new RIC still would be tax-free under 351, and the distribution of stock of the new RIC would be tax-free to the fund under section 852(b)(6). The redemption, however, would be taxable to the redeeming shareholders.

Regulations under section 355 limit the treatment of investment activities as an active trade or business. Specifically, Treas. Reg. § 1.355-3(b)(2)(iv) provides that the active conduct of a trade or business does not include: (i) the holding for investment purposes of stock, securities, land, or other property; or (ii) the ownership and operation (including leasing) of real or personal property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property. This regulatory limitation traditionally has been viewed by the IRS and many outside advisors as preventing RICs from being able to engage in a tax-free split-off under section 355.

*RIC Shareholders are Negatively Impacted when a Tax-Free Split-Off is Unavailable*

ICI's members serve over 100 million US shareholders who typically are investing for important long-term saving needs such as retirement or education. The average fund investor is of moderate means.[6]

The inability of RICs to use tax-free split-offs negatively impacts RIC shareholders by limiting an asset manager's capability to optimize the investment management services provided by the fund. While RICs may wish to use section 355 for legitimate non-tax business purposes intended to benefit these shareholders, they ultimately will avoid a division that results in additional taxable income to the investors.

As a policy matter, RICs should be able to satisfy the active trade or business requirement in section 355. RICs are engaged in an active trade or business and do not create potential for tax avoidance or abuse when one RIC separates into two or more RICs.

*RICS Are Engaged in an Active Trade or Business*

Although a RIC is not a traditional operating company, the Internal Revenue Code expressly recognizes that RICs are in a business. Specifically, the "good income" test in section 851(b)(2) refers to "other income … derived with respect to a [RIC's] *business of investing*" in stock, securities, or currencies (emphasis added). RICs also may take the deduction under section 162 for trade or business expenses. Given that RICs invest over $33 trillion for their shareholders, it is hard to argue that this business is not active.

The IRS has determined that Real Estate Investment Trusts (REITs)—which, like RICs, are taxed under Subchapter M—can be engaged in an active trade or business under section 355. Specifically, the IRS concluded in Revenue Ruling 2001-29, 2001 C.B. 1348, that a REIT's rental activity that produces income that qualifies as rents from real property under section 856(d) satisfies the active trade of business requirement of section 355(b) even though that activity is considered "passive" for purposes of Subchapter M. Equally importantly, the IRS held that the REIT was engaged in an active trade or business even though many of its activities, like those of RICs, are performed by third parties.

[6] The median household income of mutual fund–owning households in 2020 was $105,000. *See* ICI 2021 Fact Book, Figure 7.2.

In addition to their business of investing on behalf of shareholders, RICs perform other active and substantial management and operational functions through their boards. Fund directors manage and oversee the activities of the advisers, administrators, and transfer agents, which are subject to stringent legal and regulatory standards. RICs also provide many ancillary services to investors, as described above, through their advisers and other third parties. The fact that many services are provided by third parties, rather than the RIC itself, should not prevent the RIC from being engaged in an active trade or business. Indeed, the IRS has long sanctioned the substantial use of independent contractors in the active trade or business context when the nature of the industry is such that the use of independent contractors is common and perhaps even essential.[7]

*RICs Do Not Create Potential for Tax Avoidance or Abuse*

Any concern about section 355 being necessary to prevent corporations from abusing their status to avoid tax on their investment activities is inapplicable to RICs. Unlike traditional operating companies, a RIC's only business purpose is to provide a financial service for the benefit of its shareholders, i.e., purchasing, holding, and selling stock, securities, and currencies, as well as other assets related to its business of investing in stocks, securities, and currencies.

The primary purpose of the active trade or business requirement is to serve as an objective means of testing whether a transaction is being used principally as a device.[8] The purpose of the device prohibition, in turn, is to preclude a shareholder's ability to avoid the dividend provisions of the Code by using a section 355 distribution to convert what would

[7] *See, e.g.,* Rev. Rul. 73-234, 1973-1 C.B. 180 (1973) (active business requirement satisfied by reference to a farming operation in which tenant farmers, acting as independent contractors, performed all of the planting, raising, and harvesting of crops and breeding and raising of livestock in the farming operation); Rev. Rul. 73-237, 1973-1 C.B. 184 (corporation engaged in general contracting business and which made substantial use of independent contractors satisfied the active trade or business requirement.)

[8] *See* S. Rep. No. 82-781, at 58 (1951) ("all of the new corporations as well as the parent [must] carry on a business"; "nonrecognition of gain [is] denied also in cases where the reorganization [is] principally a device"); S. Rep. No. 83-1622, at 50-51 (1954) (Senate proposal will not permit "the tax free separation of an existing corporation into active and inactive entities"); *see also King v. Comm'r*, 55 T.C. 677, 696 (1971), *rev'd*, 458 F.2d 245 (6th Cir. 1972) ("[T]he raison d'être of the active conduct of trade or business requirement is to prevent the tax-free segregation of passive investment-type assets into an inactive corporate entity; thus enabling future sale at capital gains rates of the inactive portion of [Distributing's] business"); *Coady v. Comm'r,* 33 T.C. 771, 777 (1960), *aff'd,* 289 F.2d 490 (6th Cir. 1961) (The purpose of section 355(b) is "to prevent the tax-free separation of an *active corporation* into *active* and *inactive* entities") (emphasis added); Reg. § 1.355-2(d)(2)(iv)(B) (the existence of assets that are not used in a trade or business that meets the requirements of section 355(b) is evidence of device); GCM 37968 (June 1, 1979) (attached TLC Memorandum states that new regulations under section 355 will "focus on the device clause of section 355(a)(1)(B), and … make the active trade or business requirement of section 355(b) a backstop to the device clause"); B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 11.05[1] (7th ed. 2000) ("If the business has been conducted actively for five years, it presumably was not created for the purpose of avoiding the tax on dividends"); REG 123365-03 (preamble to the Proposed ATB Regulations providing that "[t]he active trade or business requirement, in tandem with the device prohibition and business purpose requirement, limits a corporation's ability to convert dividend income into capital gain through the use of a section 355 distribution. *See* S. Rep. No. 83-1622, at 50-51 (1954) and *Coady v. Comm'r*, 33 TC 771, 777 (1960), *acq.*, 1965-2 CB 4, *aff'd*, 289 F.2d 490 (6th Cir. 1961).").

otherwise be dividends taxable as ordinary income into capital gain.[9] The seminal case in this respect is *Gregory v. Helvering*, 293 US 465 (1935), in which an operating company dropped portfolio securities into a subsidiary. The corporation then distributed the shares of the subsidiary to its sole shareholder, who immediately liquidated the subsidiary, distributed the portfolio securities to herself, and sold them, thus substantially reducing her tax liability. The Supreme Court noted that the new corporation was created solely to serve the tax-reduction purpose.

The bail-out of corporate earnings generally is not a concern in the typical case in which a decision is made by a RIC to pursue a split-off to establish a new fund. Specifically, in a split-off of a portion of a RIC's assets to a group of shareholders, the new RIC's portfolio typically will include all or a portion of the original RIC's existing investment strategies, but with a distinct investor class. Such a division would not present the opportunity to sell stock of a corporation with one type of assets while retaining a corporation with a significantly different type of assets and, thereby, facilitate a device. Further if a RIC were to sell a portion of its assets and distribute the proceeds to its shareholders (rather than undertaking a spin-off), the shareholders would be entitled to capital gain dividend treatment under the provisions of Subchapter M. Thus, an intended section 355 distribution followed by a sale of the stock of the distributed RIC (if such a sale were to occur) does not present the same bailout potential as in the context of a typical non-RIC spin-off where a distribution of sales proceeds would have resulted in dividend income.

Another purpose of section 355 is to prevent circumvention of the repeal of *General Utilities*. This rationale likewise is not applicable to RICs, as section 852(b)(6) permits RICs to distribute stock or securities in-kind upon the demand of shareholders without incurring fund-level tax.

A separation of the generally incidental and passive investment activity by a traditional operating company should be scrutinized to ensure that the division is not a means for bailing out earnings and profits. These concerns do not arise in the case of RICs for the reasons stated above. If the Treasury Department and the IRS nonetheless are concerned that RICs are using section 355 inappropriately to distribute earnings and profits, the "device" requirement should be sufficient to police any potentially abusive behavior. Recognizing that RICs can be engaged in

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[9] *See, e.g., Rafferty v. Comm'r,* 452 F.2d 767, 771 (1st Cir. 1971) ("The question here is whether the property transferred to the newly organized corporation had a readily realizable value, so that the distributee-shareholders could, if they ever wished, 'obtain such cash or property or the cash equivalent thereof, either by selling the distributed stock or liquidating the corporation, thereby converting what would otherwise be dividends taxable as ordinary income into capital gain – a transaction sometimes referred to as a bail-out.'") (quoting *Wilson v. Commissioner,* 42 T.C. at 923); *Comm'r v. Morris Trust,* 367 F.2d 794, 797-98 & 800 (4th Cir. 1966) (stating that the device prohibition was first added to the statute in 1951 "as a precaution intended to encompass any other possible use of the device for the masquerading of a dividend distribution" and that "a subsequent sale of the transferor's stock, under some circumstances, might form the basis of a contention that the transaction was the equivalent of a dividend within the meaning of section 355(a)(1)(B) [of the 1954 Code] and the underlying principles"); Rev. Rul. 77-377, 1977-2 C.B. 111 ("The purpose of the device restriction of section 355(a)(1)(B) of the Code is to prevent the use of section 355 to avoid the dividend provisions of the Code"); Rev. Rul. 71-383, 1971-2 C.B. 180, (split-off that would have qualified for capital gains treatment did not constitute a device as it did not "convert dividend income into capital gains"); Rev. Rul. 64-102, 1964-1 C.B. 136 (to the same effect).

an active trade or business does not negate the need to satisfy this or the other statutory requirements under section 355.

Based on both the activities performed by a RIC and the absence of significant device concerns, we thus believe that RICs under such circumstances satisfy the active trade or business requirement under section 355. We ask the Treasury Department and the IRS to clarify that investment activity by RICs can be an active trade or business for this purpose.

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We appreciate your attention to this issue, and we will contact your offices soon to request a meeting to discuss it further. In the meantime, please contact me (202-371-5432 or kgibian@ici.org) if you have any questions.

Sincerely,

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Associate General Counsel, Tax Law

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