Tax Treatment of Mutual Fund Income From Discharge of Indebtedness Arising From an Investment in an Operating Partnership

Operating a mutual fund organized in the United States without incurring entity-level U.S. federal income tax requires compliance with a number of highly technical tests, including the so-called "gross income test." Application of the gross income test is subject to a number of uncertainties, not least of which is the treatment of income from the discharge of indebtedness, particularly when such income arises from an investment by a mutual fund in an operating partnership. This article summarizes the gross income test, describes the need for guidance in applying the gross income test with respect to income from the discharge of indebtedness arising from an investment by a mutual fund in an operating partnership, and proposes an analytical framework for future guidance in this respect.

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Mutual funds, which typically qualify as, and often are referred to as, "regulated investment companies" (RICs) for U.S. federal income tax purposes, are generally subject to entity-level tax on their taxable income. However, RICs are generally entitled to a deduction for dividends paid, which can effectively result in no entity-level tax for U.S. federal income tax purposes, achieving what is commonly referred to as the "integration" of entity level and shareholder-level taxes.[1] Qualification as a RIC is subject to a number of highly technical tests, primarily relating to the assets and income of the putative RIC.[2] One such test, commonly referred to as the "gross income test," is contained in Section 851(b)(2). No clear law currently exists regarding how income from the discharge of indebtedness under Section 108, commonly referred to as "cancellation of debt income," arising from an investment in an operating partnership is treated for purposes of the gross income test. This article begins by summarizing the gross income test. Next, it sets forth arguments as to why guidance relating to cancellation of debt income arising from an investment by a RIC in an operating partnership is much needed. Finally, an analytical framework is proposed for taxpayer-favorable guidance with respect to a RIC's cancellation of debt income arising from an investment in an operating partnership for purposes of the gross income test.

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[1] IRC § 852(b)(2). Unless otherwise indicated, all references in this article to "Section" refer to the Internal Revenue Code of 1986, as amended (the "Code").

[2] IRC § 851.

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THE GROSS INCOME TEST

In General. The gross income test is intended to ensure that substantially all of a RIC's income is investment-related, and to prevent active business income of a corporation from being eligible for tax "integration."[3] In general, under the gross income test, in order to qualify as a RIC for U.S. federal income tax purposes, a corporation must derive at least 90 percent of its gross income from certain specified sources (i.e., "qualifying income"). Qualifying income includes income derived from the following sources:

- Dividends, including deemed dividends under Section 951(a)(1)(A)(i) (relating to controlled foreign corporations) and Section 1293(a) (relating to passive foreign investment companies);[4]
- Interest, including original issue discount on short-term obligations and discount on Treasury bills;[5]
- Payments with respect to securities loans (as defined in Section 512(a)(5));

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- Gains from the sale or other disposition of securities (as defined in Section 2(a)(36) of the Investment Company Act of 1940,[6] as amended) or foreign currencies;
- Other income derived from the company's business of investing in stock, securities, or currencies (including, but not limited to, gains from options, futures, or forward contracts) (the "catch-all provision");[7] and
- Net income derived from an interest in a "qualified publicly traded partnership," as defined in Section 851(h).[8]

The flush language of Section 851(b) provides that for purposes of applying the gross income test, income derived from a partnership (other than a qualified publicly traded partnership) will be treated as described in Section 851(b)(2) only to the extent such income is attributable to items of income of the partnership which would be described in Section 851(b)(2) if realized by the partner in the same manner as realized by the partnership (the "partnership look-through rule"[9]).[10] Under the partnership look-through rule, for purposes of applying the gross income test a putative RIC is treated as owning directly its proportionate share of the assets of a partnership and as earning directly its proportionate share of the income generated by such assets.[11] In other words, a pure "aggregate" approach is applied for purposes of the partnership look-through rule.[12]

The gross income test is, as the name implies, purely a gross income test. Therefore, losses do not affect the calculation of income for purposes of the test.[13] For example, losses realized on securities do not reduce the amount of the gains realized on securities for purposes of the test,[14] and similarly, losses realized on sales of real estate cannot offset gains realized on real estate in determining whether the gross income test is satisfied.[15] Although not explicitly provided for under current law or guidance, it seems to follow that a RIC's distributive share of losses from an investment in an operating partnership, whether arising from a sale of an interest in the operating partnership or from the inclusion of such losses under Sections 702 and 704, cannot offset cancellation

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[3] See, e.g., Revenue Act of 1936: Hearings on H.R. 12395 before the Senate Comm. on Finance, 74th Cong. 799 (1936) (statement of Senator David Walsh, introducing statement of Paul C. Cabot and Merrill Griswold; statements of Paul C. Cabot and Merrill Griswold). See also Revenue Act of 1938: Hearings on H.R. 9682 before the Senate Comm. on Finance, 75th Cong. 854–855 (1938) (statement of William T. Gardiner); New York Stocks, Inc. v. Comm'r, 164 F.2d 75 (2d Cir. 1947).

[4] IRC § 851(b)(2)(A) and flush language of IRC § 851(b).

[5] IRC § 851(b)(2)(A) and Rev. Ruls. 75-225, 1975-1 CB 191 and 75-376, 1975-2 CB 267.

[6] P.L. 76-768, Investment Company Act of 1940, as amended.

[7] IRC § 851(b)(2)(A).

[8] IRC § 851(b)(2)(B). Gains from the sale or disposition of interests in qualified publicly traded partnerships are similarly qualifying income. Conf. Rept. No. 108-755 (P.L. 108-357), p. 314.

[9] IRC § 851(b)(2)(A).

[10] The flush language of IRC § 851(b) provides in relevant part,

> Income derived from a partnership (other than a qualified publicly traded partnership as defined in subsection (h)) or trust shall be treated as described in [Section 851(b)(2)] only to the extent such income is attributable to items of income of the partnership or trust (as the case may be) which would be described in [Section 851(b)(2)] if realized by the regulated investment company in the same manner as realized by the partnership or trust.

[11] See H. Rept. No. 100-795 (P.L. 100-647) p. 73.

[12] See, e.g., PLRs 9722012, 9233036, and 9847017.

[13] Treas. Reg. § 1.851-2(b)(1).

[14] Rev. Rul. 63-118, 1963-1 CB 121.

[15] Rev. Rul. 85-167, 1985-2 CB 178.

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of debt income derived by the RIC from its investment in the partnership.

Relief Available for Failure to Satisfy Test. For a RIC's taxable years for which the due date (determined with regard to extensions) is on or after December 23, 2010, relief is available for failure to satisfy the gross income test.[16] A RIC that fails to meet the gross income test for a taxable year will be considered to have satisfied such test for the taxable year if:

1. Following the RIC's identification of the failure to satisfy the test for the taxable year, a description of each gross income item that caused such failure is set forth in a schedule for the tax year filed in the manner provided by the Internal Revenue Service;[17] and
2. The failure to satisfy the test is due to reasonable cause and not to willful neglect.[18]

However, if this relief provision applies for any taxable year, a tax is imposed on the RIC equal to the excess of (1) the RIC's gross income that is not qualifying income, over (2) one-ninth of the RIC's gross income that is qualifying income (the "gross income test failure tax").[19]

> *Example:* Say a RIC has $90,000 of gross income that is qualifying income and $15,000 of gross income that is not qualifying income. The gross income test failure tax is $5,000—i.e., $15,000 – $10,000 (i.e., $90,000 ÷ 9).[20]

In other words, since 90 percent of a RIC's gross income must be qualifying income, 10 percent of a RIC's gross income may be income that is not qualifying income. However, to the extent that more than 10 percent of a RIC's gross income is not qualifying income, the gross income test failure tax is levied on such excess at a rate of 100 percent.

NEED FOR RIC GUIDANCE WITH RESPECT TO CANCELLATION OF DEBT INCOME FROM AN OPERATING PARTNERSHIP

There is no direct authority as to whether a putative RIC's distributive share of cancellation of debt income derived by an operating partnership in which such putative RIC holds a minority, passive interest is qualifying income for purposes of the gross income test. As discussed above, the principal policy underlying the test is to ensure that substantially all of a putative RIC's income is related to investment activities, and not to the active conduct of an operating business. Over time, as financial transactions and instruments have become increasingly complex and varied, the gross income test has been broadened to pick up a wide array of passive- or portfolio-type income. In particular, the catch-all provision, which was added to Section 851(b) in 1986,[21] evidences Congress's general intent that the gross income test "sweep broadly" with respect to a putative RIC's investments in stocks, securities, and currencies.

To the extent that more than 10 percent of a RIC's gross income is not qualifying income, the gross income test failure tax is levied on such excess at a rate of 100 percent.

In spite of the general broadening of the gross income test, substantial uncertainty remains as to the appropriate application of the test to certain types of income, including income derived by a putative RIC from a minority, passive interest in an operating partnership. Although there is no direct authority on point with respect to this issue, the authors believe that such authority should be provided by Treasury, the Service, or Congress for a number of reasons, several of which are discussed below.

Investments in Operating Partnerships Are Common. Investment funds, including RICs, often structure investments in operating businesses that are classified as partnerships for U.S. federal income tax purposes. Many tax professionals working with investment funds have advised on such structures or on investments to be made in them. In addition to a significant number of new and small businesses being structured as operating partnerships, a number of venerable U.S. corporations have been reorganized as operating partnerships in recent years. For example, the business once operated by Chrysler Corporation, first organized in 1925, was restructured and operated by operating partnerships known as Chrysler LLC and, subsequently, as Chrysler Group LLC.[22] Similarly, the business once known as General

[16] P.L. 111-325, § 201(d) (Dec. 22, 2010).

[17] IRC § 851(i)(1)(A).

[18] IRC § 851(i)(1)(B).

[19] IRC § 851(i)(2).

[20] Joint Committee Staff Technical Explanation of the Regulated Investment Company Modernization Act of 2010 (JCX-49-1), Sept. 28, 2010, p. 10.

[21] See § 653(b) of the Tax Reform Act of 1986, P.L. 99-514.

[22] See http://www.jbcarpages.com/chrysler/history/ (last accessed June 1, 2011).

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Motors Acceptance Corporation, first organized in 1919, was restructured and operated by an operating partnership known as GMAC, LLC, until it was subsequently reorganized as Ally Financial Inc.[23] The likelihood that a RIC could have cancellation of debt income from an investment in an operating partnership will continue to increase as more businesses are organized as operating partnerships for federal income tax purposes.

Increase in Cancellation of Debt Income and Pending Guidance in Analogous Contexts. In light of the turmoil that rippled through the financial markets beginning in 2008, it seems safe to assume that there has been a significant increase in cancellation of debt income realized by taxpayers, including investors in operating partnerships. The issue of appropriately "categorizing" cancellation of debt income has arisen in at least one context that appears to be quite analogous to the RIC gross income test. Specifically, Section 7704(c)(2) provides that a "publicly traded partnership" will *not* be classified as a corporation under Section 7704(a) if 90 percent or more of the gross income of such partnership during the taxable year is "qualifying income," as defined in Section 7704(d) (the "PTP qualifying income test"). Many of the categories of income included as "good" income under the PTP qualifying income test are analogous to the categories of "good" income included under the gross income test. In a recent comment letter, the New York City Bar Committee on Taxation of Business Entities requested guidance on cancellation of debt income under Section 7704(d) in part because of "market developments."[24] This request was recently cited by an official of the Service in reporting on impending guidance on cancellation of debt income in the publicly traded partnership context.[25] The need for guidance in the context of a putative RIC earning cancellation of debt income from an operating partnership is no less urgent.

In addition to a significant number of new and small businesses being structured as operating partnerships, a number of venerable U.S. corporations have been reorganized as operating partnerships in recent years.

Potentially Draconian Result for Inadvertent Gross Income Test Failure. In general, a RIC that does not meet the gross income test is subject to the gross income test failure tax described above. Alternatively, the company could cease to be a RIC for the taxable year, which would subject the company to regular federal corporate net income tax, which is currently imposed at a highest marginal rate of 35 percent.[26] Both of these alternatives could have harsh results, imposing significant costs on the company and, indirectly, on its shareholders.

PROPOSED ANALYTICAL FRAMEWORK FOR GUIDANCE

Based on the purpose and legislative history of the gross income test, certain analogous authorities related to the nature of cancellation of debt income, and generally liberal interpretations by the Service of the requirements for RIC status in other contexts, there are principled arguments that cancellation of debt income derived by a putative RIC from a minority, passive investment in an operating partnership should be treated as qualifying income for purposes of the gross income test.

Consistency With Plain Language and Legislative History of Gross Income Test and Catch-All Provision. As noted above, the RIC rules are designed effectively to provide tax integration to entities that are predominantly passive investors, rather than active operating businesses. Thus, the gross income test, together with the other requirements for RIC status, generally limit this treatment to companies that are organized for the purpose of, and substantially all of whose activities consist of, holding, investing, or reinvesting in stocks, securities, and currencies, as well as various financial instruments and derivatives related thereto. As discussed above, over time, the gross income test has been broadened statutorily to pick up a wide array of passive- or portfolio-type income, and the addition in 1986 of the catch-all provision appears to evidence Congress's intent that the gross income test be applied broadly to a putative RIC's "investment" income.

[23] See http://en.wikipedia.org/wiki/Ally_Financial (last accessed June 1, 2011).

[24] See "New York City Bar Report Requesting Guidance Concerning Various Provisions of Section 7704" (Jan. 10, 2011) available at http://www.nycbar.org/pdf/report/uploads/20072047-ReportReProvisionsofSection7704oftheIRCof1986.pdf. The report states,

> The provisions of the Section 7704 Regulations interpreting Section 7704(d), which defines qualifying income, likewise have not kept pace with market developments since 1995. Most urgent is the question of whether cancellation of indebtedness income is qualifying income.

[25] See John Herzfeld, "Project Due Out Soon on Cancellation of Debt Income Under Section 7704, IRS Official Says," 30 Tax Mgmt. Weekly Rep. 659 (May 30, 2011).

[26] IRC § 11.

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Initially, the authors have assumed that the putative RIC's interest in the operating partnership in question is a "security" within the meaning of Section 2(a)(36) of the Investment Company Act of 1940, as amended, and thus is a security within the meaning of Section 851(b)(2) (which incorporates by reference the 1940 Act's definition of securities).[27] Thus, from the *RIC's* perspective, any income (including cancellation of debt income) derived from its interest in the operating partnership has been "derived from" its business of investing in "securities." Therefore, cancellation of debt income derived by the RIC from its investment in an operating partnership fits within the plain language of the catch-all provision.

It is true that applying this principle broadly almost proves too much; for example, it is not likely that a RIC's share of the operating partnership's active income would be considered to fall within the catch-all provision, even though, like its share of the operating partnership's cancellation of debt income, in the RIC's hands such active income is derived from the RIC's investment in a "security." However, for the reasons discussed below, cancellation of debt income from an operating partnership should be treated differently from active income such as manufacturing and sales income, and it is more appropriate to analyze cancellation of debt income, for purposes of the gross income test, from the RIC's perspective rather than looking solely to the character of such income in the hands of the operating partnership.

In addition, treating cancellation of debt income as qualifying income would be consistent with the broadening of the gross income test to include other income derived from passive investment. The generally liberal approach to qualification as a RIC reflects a policy which does not favor penalizing or disqualifying a putative RIC as such (and thus imposing a substantial economic burden on investors) based on a highly technical reading of the qualification provisions. The Service and Congress should seek to adopt an interpretation of the relevant provisions that does not unduly penalize investors in entities whose operations and investments are generally consistent with the policies in support of RIC treatment.

Tax Character of Cancellation of Debt Income Should Be Determined at the RIC Level and Treated as Income Derived From the RIC's Business of Investing in Securities. Based on authority under other provisions of the Code, there is a strong argument that cancellation of debt income takes on more of the characteristics of a partner-level item, rather than a partnership-level item, and therefore that the catch-all provision should be applied by reference to the *partner's* business of investing in securities. This would seem to be especially true where the partner holds a small, passive, and indirect interest in the operating partnership, and where the partner has not received any *economic* income from the reduction in debt at the operating partnership level that gives rise to cancellation of debt income or otherwise from its investment in the operating partnership. A putative RIC in this context often will have been allocated a large, unexpected share of non-economic income from a passive portfolio investment which it will then sell at a large loss (generally capital) after the non-economic income was "earned" by the underlying operating partnership, with the result that it receives no economic return from its investment.

There is a strong argument that cancellation of debt income takes on more of the characteristics of a partner-level item, rather than a partnership-level item, and therefore that the catch-all provision should be applied by reference to the *partner's* business of investing in securities.

For example, Section 108(d)(6) provides that, in the case of a partnership, Section 108(a) (i.e., exclusion from gross income of cancellation of debt income) and Section 108(b) (i.e., reduction of tax attributes as a result of cancellation of debt income), among others, are applied at the partner level. Cancellation of debt income thus is neither includible nor excludable at the partnership level; rather, it is an item of "potential" income that is allocated separately to each partner under Section 702(a), and each partner then applies the Section 108 rules, with reference to its own circumstances, to determine whether the partner actually must recognize its allocable share of such income.

Section 108(i) also supports the notion that cancellation of debt income should be treated as a partner-level item. Revenue Procedure 2009-37[28] (which provides guidance and procedures for taxpayers, including partnerships, making an election under Section 108(i)) provides that a partnership may elect to defer all or a portion of the cancellation of debt income realized from the reacquisition of an "applicable debt instrument." A partnership that elects to defer less than all of its cancellation of debt

[27] Sec. & Exch. Comm'n v. W.J. Howey & Co., 328 U.S. 293 (1946).

[28] 2009-36 IRB 309 (Aug. 17, 2009).

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income may determine, in any manner, the portion (if any) of each partner's cancellation of debt income amount that is the partner's "deferred amount" and the portion (if any) of each partner's cancellation of debt income amount that is the partner's "included amount." Thus, one partner's deferred amount may be zero, while another partner's deferred amount may equal the partner's entire cancellation of debt income allocation or some portion thereof. A partner may exclude from income the partner's included amount under the relevant provisions of Section 108(a), to the extent applicable. The procedures implemented under Section 108(i) are consistent with the notion that cancellation of debt income is inherently a partner-level item, and that the consequences of realizing such income should be analyzed at the partner level.

PLR 201001005 arguably stands for the proposition that cancellation of debt income is not necessarily "bad" income for purposes of the gross income test.

Finally, the partnership rules themselves also suggest that cancellation of debt income should be treated as a partner-level item. Specifically, when a partner's share of partnership debt is reduced (including by reason of debt being cancelled or satisfied at less than its face amount), the partner's basis in his partnership interest is reduced under Sections 752(b) and 733. Thus, the reduction in debt that gives rise to the cancellation of debt income (unlike, for example, income recognized by a partnership from sales of inventory or manufacturing income) also has a *direct* partner-level consequence.

Previous Liberal IRS Interpretations of Gross Income Test in RIC Context. The Service has applied the gross income test liberally with respect to cancellation of debt income earned by a RIC. In PLR 201001005,[29] a RIC issued notes and used the proceeds to purchase a diversified portfolio of loans meeting specific investment criteria. When the RIC's notes later became available for purchase at substantial discounts from their adjusted issue price, the RIC repurchased a portion of the notes and, consequently, recognized cancellation of debt income.

In its ruling, the Service acknowledged that there is no authority as to how to treat cancellation of debt income earned by a RIC, but determined that the RIC could treat the cancellation of debt income in question as qualifying income under the catch-all provision if there was a "direct connection" between the cancellation of debt income and the RIC's business of investing in securities. Although the Service stated that the RIC was not *required* by Section 851(b)(2) to trace (within the meaning of Treasury Regulation Section 1.163-8T(a)(3)) the proceeds of the notes to the purchase of the loans, the Service determined that "the ability to trace was *one way* to demonstrate the direct connection between the cancellation of debt income and the [RIC's] business of investing in the [l]oans."[30] The Service then went on to conclude that, to the extent the proceeds of the notes could be traced to the purchase of the loans within the meaning of Treasury Regulation Section 1.163-8T(a)(3), the cancellation of debt income arising from the repurchase of the notes was "other income" derived with respect to the RIC's business of investing in securities, and hence was qualifying income for purpose of the gross income test.

Although the facts of PLR 201001005 are different than the hypothetical facts described above (and the precise test used in that ruling would, if applied to such hypothetical facts, likely produce a taxpayer-unfavorable result), the PLR arguably stands for the proposition that cancellation of debt income is not necessarily "bad" income for purposes of the gross income test, and that there might be different ways to analyze such income. The Service's statement that that ability to trace under Treasury Regulation Section 1.163-8T(a)(3) is "one way" to demonstrate a connection between cancellation of debt income and a RIC's business of investing in securities seems to open the door to other theories that could enable a putative RIC to demonstrate such a connection.

The Service has also applied the gross income test liberally with respect to other RIC income. For example, in a series of private letter rulings, the Service ruled that undistributed subpart F inclusions from RIC-owned controlled foreign corporations (CFCs) are qualifying income under the gross income test, on the theory that the "business of investing in securities" language contained in the catch-all provision should be read broadly.[31] This conclusion was reached notwithstanding the flush language of Section 851(b), which provides that CFC inclusions are only treated as *dividends* to the extent that, under Section 959(a)(1), there is a distribution by the CFC out of earnings and

[29] Jan. 8, 2010. See also PLR 201006015 (Feb. 12, 2010), which is substantially identical to PLR 201001005.

[30] Id. (emphasis added).

[31] See, e.g., PLR 200647017 (Nov. 24, 2006); PLR 201026017 (July 2, 2010).

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profits of the taxable year which are attributable to the amounts so included.

IRS Consideration of Liberal Interpretation of a Gross Income Test in Analogous Context. Moreover, the Service has considered providing relief in respect of cancellation of debt income in other similar contexts. For example, there is no authority as to the treatment of cancellation of debt income for purposes of the PTP qualifying income test. However, the Service has considered various methods under which it might provide relief to publicly traded partnerships which earn sufficient cancellation of debt income to cause a failure under the PTP qualifying income test, including applying the tracing approach adopted in PLR 201001005.[32] Like the gross income test, the PTP qualifying income test is a 90 percent gross income test, and the qualifying income test under Section 7704(d) includes numerous categories of income that qualify under the gross income test. Thus, it seems appropriate to adopt generally liberal relief measures under the gross income test, given the similar policy underpinnings of the gross income test and the qualifying income test under Section 7704(d).

Liberal Test Enacted by Congress in Analogous Context. Real estate investment trusts (REITs) are subject to a set of federal income tax rules that are very similar to those applicable to RICs, including gross income tests and a dividends-paid deduction that integrates entity-level and shareholder-level taxes.[33] Section 108(e)(9) provides that cancellation of debt income is disregarded entirely in applying the gross income tests of Sections 856(c)(2) and (3) to REITs. A similar provision in the RIC context would provide welcome relief.

Economic Circumstances Appropriate for Reaching Taxpayer-Favorable Result. Finally, disqualifying a RIC based on the cancellation of debt income attributable to the RIC's investment in an operating partnership would be a particularly harsh and non-economic result where the RIC was allocated a large, unexpected amount of non-economic income from a passive portfolio investment. This would particularly be the case where the investment was subsequently sold at a large capital loss shortly after the non-economic income was "earned" by the operating partnership, as often happens. Although the cancellation of debt income attributable to a RIC's investment in an operating partnership technically is an item of gross income, and thus apparently cannot be disregarded in applying the gross income test under current law,[34] a RIC generally cannot be said to have received any meaningful economic income from an investment in an operating partnership that generates significant cancellation of debt income, provided that the operating partnership does not otherwise generate significant economic income during the period in which the RIC owns an interest therein.

Section 108(e)(9) provides that cancellation of debt income is disregarded entirely in applying the gross income tests of Sections 856(c)(2) and (3) to REITs. A similar provision in the RIC context would provide welcome relief.

CONCLUSION

On balance, for the reasons described in this article, taxpayer-favorable guidance from the Service or a change in law by Congress relating to cancellation of debt income derived by a putative RIC that otherwise would satisfy the gross income test with respect to an investment in an operating partnership should be implemented. Such guidance or change in law could be crafted in a manner that is in keeping with the evolution of the policy underlying the gross income test and that is consistent with the approach that has been taken with respect to real estate investment trusts and which is expected to be taken with respect to publicly traded partnerships. ■

[32] See Amy S. Elliott, "ABA Section of Taxation Meeting: IRS Considering Relief for Publicly Traded Partnerships," 126 Tax Notes 607 (Feb. 1, 2010) and supra notes 24 and 25 and accompanying text.

[33] See, e.g., IRC §§ 856(c)(2), 856(c)(3), and 857(a).

[34] Cf. IRC § 108(e)(9), which provides that cancellation of debt income is disregarded entirely in applying the gross income tests of IRC §§ 856(c)(2) and (3) to REITs.

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