

# Two Recent Private Letter Rulings Provide a Rationale for Determining When Certain Derivative Contracts Will Be Considered Securities Under Code Sec. 851(b)(2) and Will Produce Qualifying Income for a Regulated Investment Company

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William P. Zimmerman and Shawn K. Baker examine two Private Letter Rulings, which conclude that certain swaps will produce qualifying income for a mutual fund taxable as a RIC under Code Sec. 851(a).

**T**his article discusses two recent Private Letter Rulings which conclude that certain swaps, including CPI swaps, will produce qualifying income for a mutual fund taxable as a regulated investment company (RIC) under Code Sec. 851(a).<sup>1</sup> In general, income from a derivative contract such as a swap will be qualifying income of a RIC if it is considered “other income” derived with respect to a RIC’s business of investing in stock, securities or foreign currencies.<sup>2</sup> For this purpose, the term “security” means a security as defined in the Investment Company Act of 1940 (the “40 Act”). If the derivative contract is itself a 40 Act security, then any income from the derivative may easily be classified as qualifying “other income” arising with respect to investing in securities.<sup>3</sup> If the derivative is not a 40 Act security,

then income from the derivative will generally be qualifying income only if the RIC can demonstrate that the investment in the derivative has a sufficient nexus to the RIC’s investment in stocks, securities or currencies. The two recent private letter rulings are significant in that they provide a rationale for determining when the IRS will treat derivative contracts as securities for purposes of determining a RIC’s qualifying income under Code Sec. 851(b)(2).

In recent years, the law regarding RIC qualifying income has developed largely with respect to RICs offering their investors an exposure to changes in commodity prices.<sup>4</sup> To place the recent private letter rulings in context, the article begins with some high-level background, including a description of some current ways in which mutual funds can obtain exposure to changes in commodities prices. The article then discusses the progression of the IRS rulings on the treatment of commodities-related instruments for purposes of the RIC qualifying income test. Finally, the article discusses the specific facts and analysis of the two rulings.

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## I. Obtaining Exposure to Changes in Commodity Prices

For at least a decade, investment advisors have sought ways to gain exposure to the commodities markets for mutual fund investors.<sup>5</sup> The main impediment to obtaining exposure to changes in commodities prices for mutual funds has been the rule that the income produced from such activities is not “good income” for purposes of the RIC gross income qualification requirement (the “Qualifying Income Test”).<sup>6</sup> Under the Qualifying Income Test, at least 90 percent of the RIC’s gross income for the tax year must be derived from:

dividends, interest, payments with respect to securities loans (as defined in Section 512(b)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investments Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies.<sup>7</sup>

The portion of Code Sec. 851(b)(2)(A) starting with “or other income ...” is referred to as the “Other Income Test.” The “Other Income Test” was added as part of the Tax Reform Act of 1986 (the “1986 Act”).<sup>8</sup> In addition, the 1986 Act included the cross-reference to the 40 Act in the parenthetical above which limits the type of stocks or securities which produce gains that will be treated as “good income” for purposes of the Qualifying Income Test. The relevant legislative history to the 1986 Act specifically addresses these expansive revisions to the Qualifying Income Test through the introduction on the Senate floor of a letter dated February 5, 1986 from Acting Assistant Secretary of the Treasury (Tax Policy) J. Roger Mentz (the “Treasury Letter”).<sup>9</sup> Although the changes made in the 1986 Act were intended to expand the Qualifying Income Test, of specific note is the Treasury Letter’s exclusion of income from trading in commodities from this expansion:

If section 851(b)(3)<sup>10</sup> is repealed, additional pressure is placed on section 851(c)(2) to limit the types of activities in which RICs may engage. We believe it is essential that two limits on the activities of RICs be retained. First, income qualifying under section 851(b)(2) should be limited to income from property held for investment, as opposed to property held for sale to customers in the ordinary course of business.

Second, income qualifying under section 851(b)(2) should be limited to income from stocks and securities, as opposed to other property. ... For example, under the second limit, we would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading is to hedge a related stock investment. ...<sup>11</sup>

As a result, while the Treasury Letter appears to provide that income and gains from direct trading in commodities will not produce “good income” under the Qualifying Income Test, the issue remained whether income from derivatives which were in whole, or in part, based on changes in commodities prices might qualify as “good income” for such purposes.<sup>12</sup>

### Treatment of Commodity-Linked Swaps

As the derivatives markets matured over the past two or three decades, mutual fund tax practitioners expressed concerns that the IRS might consider the income received with respect to certain derivatives based on changes in commodities prices as not constituting “good income” for purposes of the Qualifying Income Test.<sup>13</sup> The IRS weighed in on this issue in Rev. Rul. 2006-1,<sup>14</sup> concluding that where a RIC invested substantially all of its assets in Treasuries and entered into a derivative contract with respect to a commodity index (e.g., a swap based on changes in a commodities index), such derivative contract would not produce “good income” under the Qualifying Income Test.

### RIC Modernization Act of 2010

Representatives Rangel and Neal of the House of Representatives introduced H.R. 4337, The RIC Modernization Act of 2009, in December 2009. As first introduced, H.R. 4337 contained a provision that would have permitted RICs to include income and gains with respect to transactions in commodities and commodities derivatives as a source of “good income” under the Qualifying Income Test. Prior to its passage and signing by the President on December 22, 2010, the RIC Modernization Act of 2010 (the “RIC Mod Act”), was amended to remove the provisions treating income from commodities and commodities-linked derivatives as “good income” under the Qualifying Income Test.<sup>15</sup> As a result, the restrictions under the Qualifying Income Test with respect to transactions in commodities and commodities-linked derivatives as a source of “good income” remain issues to be dealt with by RICs and their advisors.

## Some of the Currently Available Workarounds

Following the issuance of Rev. Rul. 2006-1, a number of workarounds soon developed. RICs obtained IRS private letter rulings blessing certain of these alternatives. Notwithstanding the belief of some to the contrary, there is no grand plan or policy thinking involved in how these other alternatives developed or work together. Instead, they are merely a patchwork of workarounds of different Code provisions that provide RICs with imperfect and often indirect exposure to changes in commodities prices.

The first common workaround receiving IRS approval was the use of commodity-linked notes.<sup>16</sup> The approved notes had a payout linked to changes in a particular commodities-based index. To obtain a private letter ruling, the IRS required that the notes have certain characteristics consistent with debt instruments.<sup>17</sup> These characteristics included the requirement that the notes pay some stated coupon and provide for redemption (or “knock out”) rights under certain circumstances that provide some level of principal protection to the notes. The coupon payments and gains from investing in such notes was ruled by the IRS to be “good income” under the Qualifying Income Test. Unfortunately, the main drawbacks to commodity-linked notes reported by RIC’s advisors are the costs and counterparty risks associated with extensively using such notes.<sup>18</sup>

The second common workaround receiving IRS approval is the creation by RICs of wholly owned subsidiaries taxable as controlled foreign corporations (CFCs).<sup>19</sup> The CFCs invest primarily in commodities and commodities-related investments but may also invest in other securities. The income received by the RIC from its investment in the CFC will technically be “subpart F inclusions” under Code Sec. 951 rather than dividends (without regard to whether the CFC makes actual distributions). The IRS ruled that such income would be treated as being derived with respect to the fund’s business of investing in the stock of the CFC and therefore “good income” under the Qualifying Income Test. Limitations on the use of a CFC for a fund include (1) the limit that a RIC can invest only up to 25 percent into a CFC to keep within the RIC diversification test,<sup>20</sup> and (2) a required representation in order to obtain the ruling that limits the amount of leverage that can be used by the CFC.<sup>21</sup> These two limitations, along with the cost and complication of organizing and operating a non-U.S. corporation, are viewed by RIC advisors as significantly limiting the usefulness of the CFC approach.<sup>22</sup>

A RIC can, of course, invest directly in commodities provided the income produced from such commodities does not exceed 10 percent of the gross income of the RIC for its tax year. Generally, this is done by investing in publicly traded entities taxed as grantor trusts which, in turn, invest directly in a specific commodity (e.g., gold). A RIC, however, might encounter some difficulty if the market turns significantly against it on its “good income” investments and favorably for its “bad income” investments. For example, if a RIC experiences the recognition of a significant amount of gain or income from its “bad income” investments, the RIC may have difficulty in earning enough “good income” to comply with the Qualifying Income Test.

The RIC Mod Act, however, may now provide a slightly softer landing for a RIC failing the Qualifying Income Test. Under prior law, the failure could cause the RIC to be taxable as a Subchapter C corporation on all of its income at rates up to 35 percent. The RIC Mod Act enacted a savings provision for failure to satisfy the Qualifying Income Test that permits a RIC to cure certain failures to comply with the gross income test by making appropriate disclosure and by paying a penalty equal to the amount by which the RIC fails the test. For example, a RIC with \$90 of “good income” could have no more than \$10 of “bad income” to qualify. If the RIC has \$15 of “bad income,” it would be required to pay a penalty of \$5 (i.e., the excess of \$15 over the \$10 of bad income) in order to come back within compliance. This is still a significant penalty that, because it is based on the RIC’s gross income, could exceed the income tax due if it failed to qualify for RIC status. In addition, it remains to be seen whether this type of foot-fault would qualify for the savings provision.<sup>23</sup>

Finally, a RIC could invest in entities offered by other advisors. For example, the IRS has ruled that where a RIC makes a less-than-10-percent investment in a foreign corporation which directly invests in commodities, such investment is treated as a passive foreign investment company (PFIC) with respect to the RIC. If the RIC makes a qualifying electing fund election with respect to such PFIC, it can obtain similar treatment to an investment in its own CFC.<sup>24</sup> Similarly, a RIC can invest up to 25 percent of its assets in one or more publicly traded partnerships a principal activity of which is buying and selling commodities or options, futures, or forwards with respect to commodities (a “Commodities PTP”). Investment advisors consider this approach unpalatable, however, because it subjects their fund to fees of other advisors.

At the moment, these workarounds and direct investments can be combined to assemble a portfolio designed to obtain exposure, albeit imperfect, to changes in commodities prices.<sup>25</sup>

## II. IRS Private Letter Rulings Addressing Commodity-Related Investments

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### An Early IRS Ruling

The IRS first tackled commodity derivative investments in LTR 200440012.<sup>26</sup> A RIC requested a ruling concluding that gains from options on gold and futures contracts on gold would satisfy the Other Income Test where such options and futures contracts were entered into to reduce the RIC's risks of holding long positions in gold-related securities. The fund invested its assets in stock and securities of issuers engaged in the business of mining, processing, producing, exploring for, refining and selling gold. The fund also invested directly in gold and other precious metals. The fund desired to protect itself from adverse movements in the price of the gold-related securities and indicated that it would do so by investing in options on gold and futures contracts on gold. The advisor to the fund would evaluate a number of factors in selecting options on gold or futures contracts on gold as an economic hedge to its gold-related securities and would cause the fund to identify and record the selection and purchase of each option or futures contract on gold as an economic hedge by designating a particular gold-related security in an internal electronic mail message sent on the day the option or futures contract on the gold was purchased. A hard copy of this designation was retained, as were trade tickets and broker confirmations. The designation of the hedging transaction also appeared on the internal quarterly reports generated to record the information pertinent to all trades in options and futures contracts.

The IRS ruled that the gains derived from the option and future contracts on gold constituted good income under the Other Income Test provided that the proof of appropriate hedging and identification requirements under Code Sec. 246<sup>27</sup> and 1092,<sup>28</sup> respectively, were met. Specifically, the IRS required that, for each gold-related security, the option or futures contract on gold must:

- consist of substantially similar or related property within the meaning of the Treasury Regulations under Code Sec. 246;
- be entered into to diminish the risk of loss within the meaning of the Treasury Regulations under

Code Sec. 246 of the Code on the Fund's investment; and

- be clearly identified on the Fund's records as a hedging instrument with respect to that security, using appropriately modified versions of the Treasury Regulations under Code Sec. 1092.

The IRS indicated that by requiring the fund to comply with appropriately modified requirements under Code Secs. 246 and 1092, the IRS was able to point to certain sets of rules which provided "useful guidance in interpreting substantially similar concepts arising under Section 851(b)(2)." Following this ruling, many RIC advisors argued that the restrictions did not match the investment strategy to provide portfolio hedges rather than position hedges. They further complained that the importation of these concepts into the mutual fund investment world for this purpose proved overly restrictive, unwieldy, and/or unworkable. This ruling, however, marks the start of the IRS's progression toward permitting the hedging of a RIC's stocks and securities with options and futures on commodities.<sup>29</sup>

### Rev. Rul. 2006-1

In December 2005, the IRS issued Rev. Rul. 2006-1,<sup>30</sup> which holds that certain derivative contracts (*i.e.*, swaps) with respect to a commodity index or an individual commodity were not securities for purposes of Code Sec. 851(b)(2) under the circumstances described. In addition, the IRS ruled that the income generated from the derivative contracts was not derived with respect to the RIC's business of investing in stocks, securities or currencies. Accordingly, the gains and other income from the derivatives were not "good income" for purposes of the Qualifying Income Test.

The analysis in the ruling is broken into two sections. The first section considers whether the commodities derivatives might fall within the definition of a security for purposes of the cross-reference to section 2(a)(36) of the 40 Act. This analysis begins by observing that there was no conclusive authority addressing whether derivative contracts on commodities were included within the 40 Act's definition of "securities." Because of the lack of clarity on this issue, the ruling looks to the legislative history to the 1986 Act to find the Congressional intent in enacting the expansion of the definition of "good income" under the Qualifying Income Test. The ruling analyzes some of the same statements made in the Treasury Letter which are outlined above. The ruling noted that the Treasury Letter "... pointed out that the Service had 'often gone beyond the literal terms of the statute in

order to give reasonable interpretation to the [then current] section 851(b)(2).” The ruling then observes that the 1986 Act, as explained in the Treasury Letter, provides a special rule with respect to the gains realized from trading in foreign currencies made to hedge investments in foreign-currency denominated securities as part of the passive investment activity of a RIC. The ruling takes notice that the Treasury Letter, while arguing that foreign currency gains should be included within the “good income” category, requested that the Treasury be provided “with the regulatory authority to exclude from qualifying income any foreign currency gains that are not derived with respect to investment in a foreign-currency denominated security or from hedging activity with respect to such a security.”<sup>31</sup> The ruling concluded that the reason for the special rules applicable to currency gains was that such gains constituted income from property other than stock or securities. Moreover, the special provisions applicable to foreign currency gains were an indication that “Congress did not intend for the cross-reference to the [40 Act] to incorporate into section 851(b)(2) an expansive construction of the term ‘securities.’” Based on this special treatment for gains from foreign currencies, the ruling concludes that a construction of the term “securities” that excludes derivative contracts providing for a total return exposure to a commodity index is consistent with Congress’ intent when it amended Code Sec 851(b)(2). The ruling’s conclusion in this part of its analysis was that “... because the underlying property is a commodity (or commodity index), the [commodities-linked derivatives] that [the Fund] enters into are not securities for purposes of section 851(b)(2).”

The second part of the ruling’s analysis examined whether, even though the commodities-linked derivatives were not treated as securities, the gains from such derivatives might nevertheless be treated as “good income” under the Other Income Test of the Qualifying Income Test. The ruling, however, concluded that the RIC in question did not enter into the derivatives in connection with a business of investing in stock, securities or currencies, nor did the RIC enter into the derivatives:

“... in order to reduce or hedge the level of risk in a business of investing in stock, securities or currencies. [The RIC’s] business is to create investment exposure to changes in commodity prices, and the [derivatives] are the primary vehicle

for doing so. [The RIC] owns the debt instruments to facilitate its business of providing this commodity-derivative exposure. Because [the RIC’s derivatives] are not themselves securities and because [the RIC] does not enter into those contracts with respect to a business of investing in stock, securities, or currencies, income from the [derivatives] is not qualifying income for purposes of Section 851(b)(2).” (Emphasis original.)

This analysis focuses on a key fact which was the basis for the conclusion in the ruling on this issue: the prospectus for the RIC that was the subject of the ruling set forth that its investment strategy was to obtain exposure from commodity prices and not to seek the returns from the debt instruments. Accordingly, the conclusion in Rev. Rul. 2006-1 left unanswered the question of whether a derivative that is based in part, or in whole, on changes in commodities prices would produce “good income” if it was used by a RIC to hedge its portfolio of stocks and securities where the investment in such stocks and securities constituted the business of the fund.

### **LTR 200916016<sup>32</sup> and LTR 200652013<sup>33</sup>**

LTR 200916016 was an additional ruling requested by a RIC that originally received LTR 200652013. The RIC requesting these rulings was a business development corporation and made certain production payment loans. “Production payments” were defined as the right to minerals in place that entitled its owner to a specified fraction of production for a limited period of time or until a specific sum of money or specified number of units of mineral has been received. To reduce its price exposure to the loans it made, the RIC hedged its investments related to certain volumetric production payments (VPPs) by entering into derivative contracts that locked in the commodity prices used to set the terms of the VPPs. These derivatives were commodities-based swap contracts entered into with investment grade counterparties. In putting these positions into place, the RIC was able to match up specific swap contracts with the specific VPPs being hedged by the swap. It represented that it would identify such swaps on its books in a similar manner that a straddle is identified under Code Sec. 1092(a)(2)(B) and, in addition, would make such identification clear on its books and records on or before the close of the day it entered into the hedge. The IRS ruled that (1) gains recognized from the sale or other disposition of the production

payments was “good income” from securities under the Qualifying Income Test, and (2) gains recognized from derivatives contracts (*i.e.*, swap and option contracts) entered into by the RIC to hedge its exposure on the production payments also qualified as “good income” because the income from the derivatives contracts was “other income” derived with respect to RIC’s business of investing in securities. In the follow-up ruling of LTR 200916016, the RIC indicated to the IRS that it might purchase swap and option contracts on volumes in excess of the contractual volumes either: (1) prior to the receipt of any payments under the VPPs, or (2) after the payments had started if the RIC determined that additional hedges were needed to fully protect the RIC from price fluctuations.

Following the rationale set out in LTR 200440012, *supra*, the rulings indicated that to determine whether the RIC’s hedges actually diminish the risk of loss with respect to a particular VPP, the IRS thought it was helpful to refer to Code Secs. 246 and 1092 in that such rules would provide useful guidance in interpreting substantially similar concepts arising under Code Sec. 851(b)(2). Like in LTR 200440012, therefore, the RIC was required to represent that its activities would be consistent with the hedging concepts in Reg. §1.246-5 and the identification procedures for straddles in Code Sec. 1092. As a result, while these rulings were positive in result, they still imposed considerable restraints regarding the investment in commodities-related instruments.

### **LTR 201006015**<sup>34</sup>

In LTR 20106015, the RIC, a business development corporation, requested a ruling that discharge of indebtedness (DOI) income arising from the repurchase of certain debt instruments constituted “good income” under the Qualifying Income Test. The RIC borrowed money from a variety of sources in order to obtain capital for the purpose of acquiring equity in, and making loans to, portfolio companies in furtherance of its investment business. The RIC represented in the ruling that the proceeds from the issuance of the repurchased debt instruments was directly traceable, within the meaning of Reg. §1.163-8T, to the purchase of securities that produced “good income” for purposes of the Qualifying Income Test.

Due to the then-current economic conditions, certain debt instruments originally issued by the RIC were trading at significant discounts to their par value (or the holders thereof otherwise determined that the value of such instruments was less than their par

value). Because these debt instruments were selling at substantial discounts, the RIC believed it was in the best interests of its shareholders to repurchase some of the instruments at a discounted price prior to the maturity of the instruments. As a result of these repurchases, the RIC expected to recognize significant DOI income under Code Sec. 61(a)(12).

The IRS noted that while DOI was not specifically enumerated as one of the items of “good income” for purposes of the Qualifying Income Test, the DOI, nevertheless, might be “good income” if it was “other income” that was derived with respect to the fund’s business of investing in securities. The IRS stated that “[i]n determining whether certain income of a RIC is derived with respect to the RIC’s business of investing in securities, there must be a direct connection between the “other income” and the RIC’s business of investing in securities.”

In the ruling, the IRS noted that the debt allocation rules set forth in the Treasury Regulations under Code Sec. 163 provided useful guidance in interpreting substantially similar concepts arising under Code Sec. 851(b)(2). The IRS stated that “[a]lthough Fund is not required by section 851(b)(2) to trace the proceeds of the debt instruments to the purchase of [the securities which produced “good income”], the ability to trace is *one way to demonstrate* the direct connection between the DOI income and Fund’s business of investing in [such securities].”<sup>35</sup>

The ruling concluded that, to the extent the proceeds of the originally issued debt instruments could be traced pursuant to the Treasury Regulations under Code Sec. 163 to the purchase of securities that met the definition of securities under section 2(a)(36) of the 40 Act, the DOI income from the repurchase of the debt instruments should be treated as “good income” for purposes of the Qualifying Income Test because the DOI income is “other income” derived with respect to fund’s business of investing in securities (*i.e.*, it met the Other Income Test).

### **Observations**

Based on the above described LTRs, one can see the IRS’s progression in its comfort level in relying on other proxies found in the Code to establish a relationship between (1) the income recognized by either derivatives based on commodities, or (2) a particular type of income and the RIC’s business of investing in stocks and securities (which the RICs represented were stocks and securities under the definition of section 2(a)(36) of the 40 Act). As will be

discussed below, the two recent rulings represent an additional step forward toward loosening the “direct connection” between the income produced and the specific stocks and securities within the fund’s business of investing in such stocks and securities by no longer requiring any reference to rules under other provisions of the Code.

### III. The Two Rulings—LTR 201103036<sup>36</sup> and LTR 201106006<sup>37</sup>

In LTR 201103036, the RICs invested in equity securities of domestic or international companies. The RICs desired to enter into swaps on securities or securities indices in order to manage price risk with respect to the equity securities in their portfolios and as an alternative investment to direct ownership of the underlying securities. The RICs planned to enter into certain derivative financial transactions to manage the effects of inflation on the values of securities on a portfolio-wide basis. These derivatives included interest rate swaps, constant maturity swaps, and Consumer Price Index swaps (“Swaps”). The ruling then discussed the characteristics of the various types of swaps which would be entered into by the RICs.<sup>38</sup>

In LTR 201106006, the RIC invested in a portfolio of municipal securities. The RIC intended to obtain full inflation hedging coverage for its municipal bond portfolio by entering into CPI-U NSA based swap contracts (“CPI Swaps”) with investment grade counterparties. The RIC’s advisor intended to cause RIC to enter into CPI Swaps when it purchased municipal bonds in notional principal amounts approximating the market value of such municipal bonds. The hedging process to be entered into by the RIC would be conducted on a “passive” basis, meaning the RIC would be likely to vary the amount of the CPI Swaps only in a manner corresponding to any changes made in the underlying portfolio of municipal bonds. The CPI Swap in question referenced the Consumer Price Index Urban Non-Seasonally Adjusted (“CPI-U NSA”), which is a non-seasonally adjusted measure for estimating inflation by referencing changes in the price levels for urban consumers of a standard basket of goods and services. Because inflation equates to a diminished value of a currency, the RIC intended to enter into the CPI Swaps in order to manage the effect of inflation upon the value of the portfolio by receiving inflation indexed payments.

The analysis in both rulings is identical. The rulings first describe the expansion of the Qualifying

Income Test in the 1986 Act and then set forth the definition of a “security” in section 2(a)(36) of the 40 Act. The rulings conclude that the Swaps in question are not stock, debt instruments or currency (or options, futures or forward contracts with respect to stock, debt instruments or currency). Further, the rulings cite to Rev. Rul. 2006-1 for the conclusion that a swap is not specifically enumerated as a security under section 2(a)(36) of the 40 Act nor is there any conclusive authority that interprets such definition to include a swap. The rulings then observe that, nevertheless, the Swaps may fall within the Other Income Test “if the Swaps are securities for purposes of Section 851(b)(2).” The analysis then notes that while the SEC generally interprets the securities laws broadly, in determining whether a financial instrument is a “security for purposes of Section 851(b)(2), the Service applies principles of tax law, including those of subchapter M of the Code and accompanying legislative history, to analyze a financial instrument that is not specifically enumerated as a security under the 1940 Act.”

Several factors in the analysis to be conducted are set forth, “including, but not limited to, the following: (1) the nature of the derivative’s underlying referent; (2) the tax principles and the Congressional intent underlying the enactment and amendment of subchapter M of the of the Code, including the effects of the 1986 amendments to section 851(b)(2), which added the “other income” provisions and the cross-reference to the definition of securities in the 1940 Act; and (3) the extent to which a RIC generates income and gain from the derivative that is passive in nature and akin to the passive income that the RIC generates from securities enumerated as such under the 1940 Act.” The rulings go on to conclude that the Swaps described “are securities for purposes of section 851(b)(2) and, accordingly, that income generated by [the RICs’] investments in the Swaps is “other income” that is qualifying income under section 851(b)(2).”<sup>39</sup>

### Preliminary Observations

The 1986 Act was not the first time that 40 Act definitions have been incorporated into the rules governing qualification of an investment fund as a RIC. Code Sec. 851(c)(6) previously incorporated a number of 40 Act terms for purposes of a separate diversification requirement. In dealing with such incorporated 40 Act terms, the IRS generally took the view that it was free to come to its own interpretation of the

term, and could take tax principles into account in so doing, absent a definitive interpretation of the term by the Securities and Exchange Commission (the “SEC”).<sup>40</sup> When the SEC adopted a regulation to characterize as “government securities” certain repurchase agreements and refunded bonds fully secured by government securities, the IRS accepted the regulation as a definitive construction of the term “government securities” that would also apply for purposes of the RIC diversification requirement. In so doing, it explained that:

The RIC diversification rules of subchapter M are substantially similar in structure and purpose to those of the 1940 Act. Both sets of rules impose numerical limitations on the percentages and types of assets that may be held by an investment company. Both are intended to protect the investor from the risks of loss and of illiquidity inherent in the concentration of assets in the securities of a single or a small number of issuers. See H.R. Rep. No. 2020, 86th Cong., 2d Sec. 820-26. In view of the commonality of structure and purpose of both sets of rules and in view of the need for RICs simultaneously to comply with both, the diversification provisions of the Code and those of the 1940 Act should be interpreted consistently.<sup>41</sup>

The rulings can be read as suggesting that the IRS would feel less constrained to follow a definitive SEC interpretation of the term “security” in view of Rev. Rul. 2006-1 and the legislative history with respect to trading in commodities. Instead, the rules set forth a rationale indicating that, when determining whether a derivative instrument is, or is not, a security as defined in the 40 Act, the IRS will consider a number of factors, including, but not limited to, those it has articulated in the rulings. This appears to be a logical extension and affirmation of Rev. Rul. 2006-1, which articulated the reasons why, in the face of the uncertainty associated with whether or not commodities-linked swaps were 40 Act securities, the IRS needed to step out of the confines of the words of the statute to take into account Congress’ intent when it included the 40 Act cross-reference. As explained below, the IRS will use this analysis both to exclude certain types of derivative instruments and to include certain derivative instruments as securities for purposes of the Qualifying Income Test under Code Sec. 851(b)(2).

The analysis of the rulings then turns to examine the three different factors that the IRS considered in

reaching its conclusion: (1) the underlying referent; (2) the Congressional intent; and (3) the passive nature of the income.

In analyzing the underlying referent, the rulings note the conclusion reached in Rev. Rul. 2006-1 that Congress consistently excluded commodities from the definition of a security and therefore that ruling appropriately concluded that a derivatives contract on a commodities index should not produce “good income” under the Qualifying Income Test.<sup>42</sup> The rulings observe that “[a]lthough the CPI includes the value of certain baskets of commodities in measuring the average change in prices over time of goods and services of households, the annual percentage change of the CPI is predominantly used as a measure of inflation.” This differentiated the CPI Swaps from the commodities-linked swaps discussed in Rev. Rul. 2006-1. No additional guidance was provided as to what “predominately” means for this purpose.<sup>43</sup>

The rulings then discuss the Congressional intent surrounding the changes made in the 1986 Act. The IRS noted that the 1986 Act was intended to bless the IRS’s prior rulings, which concluded, for example, that income from certain derivative contracts on stock and securities was “good income” for purposes of the Qualifying Income Test. In addition, prior to the 1986 Act, the IRS ruled that income from exchange traded futures contracts on U.S. Government securities, futures contracts on financial instruments, futures on domestic and Eurodollar certificated of deposits and other interest rate contracts were found to be securities under Code Sec. 851(b)(2). The IRS concluded that the pricing and economics made the Swaps akin to the instruments that the IRS previously determined to be Code Sec. 851(b)(2) securities.

The final analysis section of the rulings explained that Congress intended the RIC provisions to apply to passive investment entities and not to active businesses and that a RIC’s investments should be limited to income from stocks and securities, as opposed to other property. After repeating the above excerpt from the Treasury Letter regarding the restriction on trading by RICs in commodities, even if the purpose is to hedge a related stock investment, the IRS concluded that the income that a RIC generates from its investment in Swaps is passive in nature in the same way investments in other Code Sec. 851(b)(2) securities is passive. “Like an investment in Treasury Inflation Protected Securities (TIPS) (the principal of which increases with inflations and decreases with deflations, as measured by the CPI), [the RICs] utilize

a CPI swap to capture inflation accrual and not as a surrogate for investment in active trading in commodities or other goods and services.”<sup>44</sup>

## Further Observations

As a general proposition, one might say that the intent of the definition of RIC qualifying income in Code Sec. 851(b)(2) has always been, even before the adoption of the Other Income provision by the 1986 Act, that all income from investments in stocks and securities will be “good income.” However, the provision actually refers to specific types of income from stocks and securities, such as dividends, interest and gains from the sale or other disposition of stock and securities. Over the years, specific provisions added payments with respect to securities loans and subpart F inclusions from investments in CFCs. The result is that it is necessary to resort to the Other Income provision to cover certain types of income from investments in stocks and securities that do not fit within one of the specific categories of good income. This is why, for example, over 40 LTRs have been issued to confirm that subpart F inclusions will be good income even though the RIC receives the investment directly from an investment in stock, the CFC stock.

Even if a derivative instrument is held to be a 40 Act security, the income from the security may not fit within one of the specific categories of good income.

For example, if an interest rate swap provides for periodic payments and is, therefore, a notional principal contract, a RIC receiving payments from the swap will realize ordinary income that is not a dividend, interest, or gain from a sale or other disposition of a security.<sup>45</sup> So here too resort must be had to the Other Income provision of the Qualifying Income Test.

If a derivative instrument is not a 40 Act security, the RIC must demonstrate that its investment in the derivative instrument has a required nexus to other investments of the RIC that do qualify as stock or 40 Act securities. As discussed above, the IRS has made reference to various other provisions of the Code to find guidelines for establishing such a nexus; and RICs and their advisors have found the results somewhat constraining.

The conclusion reached in the rulings that a particular derivative instrument is a security under Code Sec. 851(b)(2) greatly simplifies the remaining analysis required for application of the Other Income provision. Income that results directly from the investment in a security Code Sec. 851(b)(2) would always be considered good income” under the Other Income Test, without a need to establish a nexus with other investments that the RIC makes. Accordingly, the issuance of the rulings is a very welcome development in providing the analysis the IRS will use to determine whether a derivative instrument is a security for purposes of Code Sec. 851(b)(2).

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<sup>1</sup> References herein to the Code are to the Internal Revenue Code of 1986, as amended.

<sup>2</sup> See Code Sec. 851(b)(2)(A) as set forth in its entirety in the text below, at footnote 6.

<sup>3</sup> RIC qualifying income also includes certain specified types of income, such as dividends, interest and gains. The statement in text assumes the income from the derivative will not necessarily fit within one of the specified types of income and must there qualify under the broader “other income” category. That assumption is discussed in greater detail at the conclusion of this article.

<sup>4</sup> In addition, the IRS has issued a private letter ruling concluding that a RIC can currently invest in foreign currency forward contracts and other foreign currency related investments without the need to directly relate those investments to the RIC’s principal business of investing in stock or securities (or options and futures with respect to stock or securities) until such time as these regulations are promulgated. See LTR 200602032 (Jan. 13, 2006).

<sup>5</sup> IR-2005-142 (Dec. 16, 2005), 2005 TNT 242-17 (Dec. 19, 2005) (“Many investment

managers consider commodity exposure an important component of investors’ overall portfolio, in part as a hedge against inflation. Investments that create this exposure include exchange-traded commodity futures contracts and interests in commodity-trading partnerships. Historically, however, mutual funds did not offer this exposure directly, because, under the tax law applicable to these funds, direct investments in commodities do not generate qualifying income for a mutual fund.”)

<sup>6</sup> See Code Sec. 851(b)(2). For detailed discussions of these rules, see James R. Brown, Jr., *Recent IRS Rulings on Commodity-Linked Instruments and the Proper Scope of Mutual Fund Taxation*, 112 TAX NOTES 505 (Aug. 7, 2006); Stevie Conlon, *IRS Ruling Severely Restricts Fund Investments in Commodity Linked Derivatives*, 23 J. TAX’N INVEST. 202 (2006); and Robert Willens, *Commodity Futures: Off Limits for RICs*, 112 TAX NOTES 65 (July 3, 2006).

<sup>7</sup> Code Sec. 851(b)(2)(A). Pursuant to Code Sec. 851(b)(2)(B), qualifying income also includes “net income derived from an inter-

est in a qualified publicly traded partnership ...”

<sup>8</sup> P.L. 99-514 (1986), §653(b).

<sup>9</sup> H. REP. NO. 99-84, Conference Committee Report on the Tax Reform Act of 1986 (Sept. 18, 1986).

<sup>10</sup> Former Code Sec. 851(b)(3) imposed a limit on a RIC’s gains from short-term trading activities for a tax year denying RIC status unless less than 30 percent of its gross income was derived from the sale or disposition of certain investments held for less than three months.

<sup>11</sup> 132 Cong. Rec. S2, 2268-03 (1986) (letter of J. Roger Mentz, Acting Asst. Sec. (Tax Policy) Dep’t of Treas. to Rep. Flippo dated February 5, 1986, included in statement of Sen. Armstrong).

<sup>12</sup> See IR-2005-142, note 4 *supra*. Cf. LTR 20044012 (Oct. 1, 2004), discussed below where the IRS ruled that options and futures contracts on gold which were entered into to hedge gold related securities produced “good income” under the Qualifying Income Test.

<sup>13</sup> *Id.*

<sup>14</sup> 2006-1 CB 261, *as modified and clarified*

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by Rev. Rul. 2006-31, 2006-1 CB 1133.

- <sup>15</sup> At least one group submitted a letter to the Senate raising concerns that if RICs were permitted to invest in commodities, it would be disruptive to such markets and would expose RICs to these “risky investments.” See, letter from Commodity Markets Oversight Coalition (CMOC) to U.S. Senate, dated November 24, 2010 (“Although many mutual funds are eager to expand their financial commitments in commodities, such investment strategies are extremely risky. Additionally, many now utilize commodity index and exchange-traded funds, which employ a controversial ‘passive’ investment strategy that some argue leads to excessive speculation and volatility in commodity markets, including energy and agriculture.”) It appears that such provisions were dropped from the legislation to permit the prompt approval of the remainder of the bill. It is unclear if or when the deleted provisions will be reconsidered.
- <sup>16</sup> See, e.g., LTR 200628001 (July 14, 2006).
- <sup>17</sup> Characteristics of commodity-linked notes vary greatly which is why LTRs continue to be pursued by RICs to cover their particular notes. In addition, there remains uncertainty regarding whether certain of these notes should be treated as debt instruments or prepaid forward contracts for federal income tax purposes.
- <sup>18</sup> In addition, a fund must comply with the RIC diversification test under Code Sec. 851(b)(3), which might mean that no more than 25 percent of its assets can be invested in one counterparty’s notes.
- <sup>19</sup> See, e.g., LTR 200647017 (Nov. 24, 2006). For a detailed discussion regarding this ruling see Dale Collinson, *Qualifying Income of a RIC from Investment in a CFC*, 114 TAX NOTES 673 (Feb. 12, 2007).
- <sup>20</sup> An interesting question is whether a RIC can

create more than one CFC where they invest in different commodities. Under, Code Sec. 852(b)(3)(B)(ii) a RIC may not invest more than 25 percent of the value of its assets in the securities of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses. For example, would an investment in metals by the CFC be in the same trade or business as an investment in an agricultural commodity by a different CFC? This may require answering the question as to whether an investment in one commodity (e.g., gold) is a trade or business in the first place. If it is not, then Code Sec. 851(b)(3)(B)(ii) might not apply and a mutual fund might be able to invest in more than one wholly owned CFC and still satisfy the RIC diversification test.

- <sup>21</sup> The IRS requires the RIC to represent that, although the CFC will not be registered as an investment company under the 40 Act, the CFC will still comply with the requirements of section 18(f) of the 40 Act, Investment Company Act Release No. 10666, and related SEC guidance pertaining to asset coverage with respect to transactions in commodity index swap agreements and other transactions in derivatives.
- <sup>22</sup> CFCs have come under criticism by the National Futures Association (NFA). In the NFA’s recent petition to amend CFTC Rule 4.5 to limit the ability of RICs to invest in commodities and commodities futures without CFTC registration, they stated as follows: “NFA also has customer protection concerns relating to these mutual funds’ use of a wholly-owned and controlled subsidiary to invest in commodity futures transactions on behalf of the fund.” Petition for Rulemaking to Amend CFTC Regulation 4.5 (Aug. 18, 2010).
- <sup>23</sup> See Code Sec. 851(i). To qualify for the

savings provision, the failure must “be due to reasonable cause and not due to willful neglect.”

- <sup>24</sup> See, e.g., LTR 201039002 (Oct. 1, 2010).
- <sup>25</sup> A RIC combining a CFC and a Commodities PTP, would have to take care that it doesn’t violate the “control” test in ownership of Code Sec. 851(b)(3)(B)(ii). Control for these purposes is generally 20 percent of the total combined voting power of all classes of stock entitled to vote. Code Sec. 851(c)(2). That is, if the RIC were to control both entities, then the 25-percent investment limit discussed in note 18, *supra*, would apply.
- <sup>26</sup> LTR 20044012 (Oct. 1, 2004).
- <sup>27</sup> Code Sec. 246 provides, in part, certain rules affecting an investor’s holding period for purposes of the dividends received deduction when the investor’s risk of loss with respect to the dividend paying stock has been diminished by certain hedging activities and provides definitions of the terms “substantially similar or related property and “diminished risk of loss.”
- <sup>28</sup> Code Sec. 1092 and the Treasury Regulations thereunder provide detailed rules on identification of certain straddle positions.
- <sup>29</sup> This development occurred even though the Treasury Letter indicated that trading of commodities would not give rise to qualifying income even if the purpose of the trading was to hedge a related stock investment. See text accompanying note 11 *supra*.
- <sup>30</sup> *Supra* note 14.
- <sup>31</sup> Treasury Letter, at 4048.
- <sup>32</sup> LTR 2009156016 (Dec. 11, 2008).
- <sup>33</sup> LTR 200652013 (Dec. 29, 2006).
- <sup>34</sup> LTR 201006015 (Nov. 4, 2009).
- <sup>35</sup> (Emphasis added.) The fund in the ruling represented that the securities purchased with the proceeds of the debt instruments it issued were securities under section 2(a)

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(36) of the 40 Act.

<sup>36</sup> LTR 201103036 (Sept. 22, 2010).

<sup>37</sup> LTR 201106006 (Oct. 28, 2010).

<sup>38</sup> In an interest rate swap, the fund would enter into an agreement with a counterparty to exchange periodic payments based on an agreed-upon periodic interest rate multiplied by a notional principal amount. For example, in a "plain vanilla" interest rate swap, the fund might make periodic payments based on a floating rate and may receive payments based on a fixed rate, or *vice versa*. In a constant maturity swap (CMS), the fund would make periodic payments based on a short-term floating interest rate in exchange for payments based on a constant maturity rate (*e.g.*, a five-year interest rate). A CMS swap would permit the fund to execute a trade that references the actual interest rate in a certain number of years. A Consumer Price Index swap references the Consumer Price Index (CPI), which is a measure for estimating inflation by referencing

changes in the price levels of a standard basket of goods. Because inflation equates to a diminished value of a currency, a CPI swap may be entered into in order to manage the effect of inflation upon the value of the portfolio.

<sup>39</sup> Note the specific wording used by the IRS did not conclude that the Swaps were 40 Act securities, but instead that they were to be treated as such (*i.e.*, as securities under Code Sec. 851(b)(2)) for purposes of the Qualifying Income Test.

<sup>40</sup> See, *e.g.*, GCM 38994 (May 27, 1983) (U.S. Treasury bill futures contract are treated as securities for purposes of Code Sec. 851(b)(2)).

<sup>41</sup> Rev. Rul. 2003-84, 2003-2 CB 280; accord, Rev. Proc. 2004-28, 2004-1 CB 984.

<sup>42</sup> In making that observation, the rulings may have stated an overly broad characterization of the conclusion in Rev. Rul. 2006-1. As discussed in text above, the IRS has issued LTRs holding that certain derivative contracts on commodities do produce "good income"

under the Qualifying Income Test when such derivative contracts were entered into for hedging purposes. The rulings might have said more accurately that Rev. Rul. 2006-1 correctly concluded that commodity derivatives should not be considered 40 Act securities.

<sup>43</sup> BLACK'S LAW DICTIONARY (5th ed.) provides that "predominant" means "something greater or superior in power and influence to others with which it is connected or compared."

<sup>44</sup> With respect to the ruling for the RIC investing in municipal securities, the IRS stated: "[i]n the case at hand, Fund is, in essence, replicating the benefits of the inflation protection of TIPS with the base securities being municipal bonds instead of U.S. Treasury securities. The two investments will generate income whose character is equally passive in nature, despite the fact that the CPI Swap structure adds counterparty risk and additional costs that a portfolio of TIPS avoids."

<sup>45</sup> See Reg. §1.446-3(d); Proposed Reg. §1.1234A-1(b).

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