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## IRS Issues Proposed Regulations Relating to the Treatment by Regulated Investment Companies of Income from Subsidiaries Investing in Commodities

Authored by Richard Hervey, Jeffrey Sion, Ari Zak, Daniel Dunn and Jay Buchman

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## Summary

The IRS has recently issued Proposed Regulations<sup>1</sup> under Section 851(b) of the Internal Revenue Code<sup>2</sup> (the “Proposed Regulations”), and a Revenue Procedure that address the treatment to regulated investment companies (“RICs”) with respect to income from certain commodities-linked notes (“CLNs”) and income from subsidiaries investing in commodities and commodities derivatives.

The preamble to the Proposed Regulations provides that the IRS will no longer issue private letter rulings (“PLRs”) on whether income from a financial instrument or position (such as CLNs) is income from a “security” under §2(a)(36) of the Investment Company Act of 1940, that would therefore be qualifying income for purposes of the income test applicable to RICs. Simultaneously with the release of the Proposed Regulations, the IRS issued a revenue procedure to this effect (the “Revenue Procedure”).<sup>3</sup>

The Proposed Regulations also provide that amounts included in income by a RIC in respect of a foreign corporation that is a controlled foreign corporation (“CFC”), or is a passive foreign investment company (“PFIC”), subject to a qualified electing fund (“QEF”) election, will be treated as dividends (and thus as qualifying RIC income) only to the extent that the earnings attributable to such income are timely distributed by the foreign corporation to the RIC. Unlike the approach taken in PLRs previously issued by the IRS, the Proposed Regulations also provide that an income inclusion under the CFC or PFIC QEF rules is not qualifying RIC income as other income derived from a RIC's business of investing in stock, securities, or currencies.

## A. Background on Regulated Investment Companies

The Code contains special rules relating to the taxation of RICs. Under §851(a), a U.S. corporation (or entity otherwise taxed as a corporation) is generally able to qualify as a RIC for a taxable year if it is either registered, at all times during the taxable year, with the Securities and Exchange Commission (“SEC”) as a management company or unit investment trust under the Investment Company Act of 1940, as amended (the “1940 Act”), or has in effect an election under the 1940 Act to be treated as a business development company.

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<sup>1</sup> REG-123600-16, 2016-43 I.R.B. 523. The Proposed Regulations, if adopted, would apply to taxable years on or after 90 days after the regulations are published as final.

<sup>2</sup> Unless otherwise specified, all section or § references are to sections of the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>3</sup> Rev. Proc. 2016-50, 2016-43 I.R.B. 522, applicable to all requests for letter rulings, including any requests pending in the IRS National Office and any requests submitted on or after September 27, 2016.

Section 851(b) limits the §851(a) definition of a RIC by providing that an eligible corporation shall not be considered a RIC for a taxable year unless it makes, or has made an election to be a RIC, and also satisfies certain requirements relating to the source of its income and the diversification of its assets.<sup>4</sup>

Under §851(b)(2), a RIC must derive at least 90% of its gross income from dividends, interest, payments with respect to certain securities loans, and gains from the sale or other disposition of stock or securities (as defined in §2(a)(36) of the 1940 Act), 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, or net income derived from interests in certain qualified publicly traded partnerships (the “qualifying income requirement”).<sup>5</sup>

Under §851(b)(3), a RIC must also satisfy certain diversification requirements with respect to its assets, generally at the close of each quarter of the taxable year.<sup>6</sup>

A RIC that satisfies certain minimum distribution requirements<sup>7</sup> is generally taxed as a pass-through entity that acts as a partial conduit of income and gains to its shareholders.

## B. Prior Revenue Rulings and Private Letter Rulings Involving Commodities

### 1. Revenue Rulings

The IRS has generally treated income from investments in commodities and derivatives on commodities as not being qualifying income for purposes of the qualifying income requirement. In Rev. Rul. 2006-1,<sup>8</sup> the IRS ruled that a derivative contract entered into by a RIC that provides for a total return exposure on a commodity index is not a security for purposes of §851(b)(2) and that income from such a derivative contract is not qualifying income. Under the derivative contract, the RIC would pay the counterparty an amount based on a Treasury bill rate plus a spread and would be entitled to receive (or required to pay) an amount based on the total return on the commodity index. The ruling stated that there is no “conclusive authority” as to whether the derivative contracts on commodities are included in the definition of securities under §2(a)(36) of the 1940 Act. The ruling also concluded that the changes made to §851(b)(2) by the Tax Reform Act of 1986 (“1986 TRA”) were not intended to include gains from trading in commodities as qualifying income.

Rev. Rul. 2006-1 also concluded that income from the derivative contract on the commodity index did not qualify as “other income” under §851(b)(2) because, under the facts stated in the ruling, the RIC 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

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<sup>4</sup> §851(b)(2), §851(b)(3).

<sup>5</sup> A RIC must also make an election to be a RIC under §851(b)(1). A company must also satisfy certain minimum distributions requirements with respect to a taxable year under §852(a), in order to qualify for treatment as a RIC with respect to such taxable year.

<sup>6</sup> §851(b)(3).

<sup>7</sup> §852(a).

<sup>8</sup> 2006-1 C.B. 261, as modified by Rev. Rul. 2006-31, 2006-1 C.B. 1133.

contracts in order to reduce or hedge the level of risk in a business of investing in stocks, securities, or currencies.<sup>9</sup> The RIC instead entered into the derivatives to create investment exposure to commodity prices.

Rev. Rul. 2006-1 was applied on a prospective basis to income recognized after June 30, 2006. This effective date was further extended by Rev. Rul. 2006-31,<sup>10</sup> which stated that the IRS will not apply the principles of Rev. Rul. 2006-1 adversely with respect to amounts of income recognized on or before September 30, 2006, by a taxpayer from a derivative contract (including an option, futures, or forward contract) on a commodity index or an individual commodity.

*Comment:* Rev. Rul. 2006-31 indicates that the IRS does not generally view income or gains from a derivative contract (including an option, futures, or forward contract, or swap) on a commodity index or on an individual commodity as qualifying income under §851(b)(2).

## 2. Private Letter Rulings Involving Investments in Commodities-Linked Notes

Rev. Rul. 2006-31 also stated that Rev. Rul. 2006-1 “was not intended to preclude a conclusion that the income from certain instruments (such as certain structured notes) that create a commodity exposure for the holder is qualifying income under section 851(b)(2).”

The IRS subsequently issued a substantial number of PLRs which concluded that income and gains from certain notes linked to a commodity index are qualifying income under §851(b)(2).<sup>11</sup>

As an initial matter, the notes covered by the PLRs satisfied the requirements for a hybrid instrument to be predominantly a security under §2(f)(2) of the Commodity Exchange Act.<sup>12</sup> Under these requirements:

- The issuer of the note must receive payment in full of the purchase price of the note substantially contemporaneously with the delivery of the note;
- The RIC, while holding the note must not be required to make any payment to the issuer of the note in addition to the purchase price paid for the note, whether as margin, settlement payment, or otherwise, during the life of the notes or at maturity;
- The issuer of the note must not be subject by the terms of the instrument to mark-to-market margining requirements of the Commodity Exchange Act; and
- The note must not be, and will not be, marketed as a contract of sale of a commodity for future delivery (or option on such a contract) subject to the Commodity Exchange Act.

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<sup>9</sup> The IRS has issued certain PLRs that provide in certain cases a derivative that acts as a hedge to securities may be treated as qualifying income. See e.g. PLRs 200440012, 200652013.

<sup>10</sup> 2006-1 C.B. 1133.

<sup>11</sup> See, e.g., PLRs 201135001, 201131001, 201108018, 201108003, 201107012, 201104013, 201043016, 200822012, 200705026, 200701020, 200647017, 200637018, and 200628001.

<sup>12</sup> 7 U.S.C. 2.

In addition to the criteria in the Commodity Exchange Act listed above, the notes covered by the PLRs required certain other features that were generally intended to limit the value of the contingent commodity return as compared to the fixed return under the note. The approved notes typically had the following characteristics:

- The notes were based on a broad-based commodity index or on a sub-index of a broad-based commodity index with at least two commodity components.
- The notes were issued at par value.
- The notes paid interest at a coupon rate which was typically payable either quarterly or on maturity.
- The principal payable under the notes was based on a formula that included a leverage factor of no greater than 3.0 (i.e. the formula included a change in principal based on no more than three times the movement in the underlying index).
- The notes typically had a maturity of slightly more than one year.
- The RIC was able to put the note to the issuer on any business day with a specified notice period.
- The notes would be automatically triggered and redeemed (based on the next day's price) upon a specified drop in the index and/or principal payment formula. If the trigger was based upon a specified drop in the principal payment formula the trigger was typically no greater than 45% of the original principal. If the trigger is based on a drop in the index then the trigger was typically no greater than 45% divided by the leverage factor. As an example, if the leverage factor is three, the trigger could be a 15% drop in the index.

### 3. Investments in Subsidiaries Investing in Commodities

The IRS also issued a substantial number of PLRs involving RICs that intended to form a wholly-owned offshore subsidiary that would be taxed as a CFC, which was intended to invest in derivatives on commodities.

If a RIC directly, or indirectly, owns at least 10% of the stock in a CFC, the RIC generally must include in its gross income its pro rata share of the CFC's "subpart F income" under §951(a)(1)(A)(i), even if the CFC does not distribute that income to its shareholders. Such subpart F income inclusion normally does not technically qualify as a "dividend," because §316 defines a "dividend" as a distribution of property by a corporation to its shareholders that meets certain requirements.<sup>13</sup> Section 959(a)(1) generally provides that, if a CFC does make distributions to its shareholders, such distributions are not included in the gross income of shareholders to the extent that such amounts are, or have been, included in the gross income of the shareholders under §951(a).

Thus, as a general matter, a U.S. shareholder in a CFC normally does not technically have "dividend" income with respect to subpart F inclusions under §951(a), because amounts of subpart F income included under §951(a) are not dividends and any related distributions actually received are not included in gross income under §959(a)(1) because generally the amounts have already been included in taxable income by the U.S. shareholder.

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<sup>13</sup> See also Reg. §1.951-1(a)(2).

Section 851(b) and the regulations thereunder<sup>14</sup> provide a special rule that amounts included in a RIC's gross income as subpart F income under §951(a)(1)(A)(i) are treated as dividend income for purposes of the qualifying income requirement under §851(b)(2) to the extent that under §959(a)(1) there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included (the "RIC CFC Dividend Rule").

Thus, under the RIC CFC Dividend Rule, a RIC generally should be able to treat subpart F income as qualifying dividend income, for purposes of the qualifying income requirement under §851(b), to the extent that it receives distributions of such subpart F income.

*Comment:* The RIC CFC Dividend Rule was added to §851 in 1975, at a time when RIC qualifying income was generally limited to dividends, interest and gains from stocks and securities. A similar rule was also added by the 1986 TRA to include distributions received by a RIC from a PFIC on which the RIC made a QEF election under §1293(a) (a "PFIC QEF").

After the amendments to §851(b) made by the 1986 TRA, subpart F income with respect to stock in a CFC, and any other income or gains from stock in a CFC, as well as income inclusions from a PFIC QEF could be viewed as qualifying income under §851(b)(2), even if such income is not distributed to the RIC, because such income should be considered "other income ... derived with respect to [the RIC's] business of investing in stock." The IRS initially agreed with this approach in several PLRs<sup>15</sup> involving RICs that intended to form a wholly-owned offshore subsidiary that would be taxed as a CFC, which was intended to invest in derivatives on commodities. The initial PLRs concluded that income derived by the RIC from its investment in its wholly-owned subsidiary, whether or not attributable to subpart F income, would be income derived with respect to the RIC's business of investing in the stock of the subsidiary and would thus be qualifying other income to the RIC under §851(b)(2).<sup>16</sup> Subsequent PLRs limited their holding to subpart F income attributed to the RIC from the subsidiary.<sup>17</sup>

*Comment:* An offshore subsidiary of a RIC that invests in commodities and derivatives on commodities will be treated as a CFC and the RIC will generally need to include subpart F income earned by the CFC in the RIC's ordinary income, irrespective of whether such subpart F income is distributed by the offshore subsidiary to the RIC.

*Comment:* It should be noted that the conclusion reached by the IRS in prior PLRs which held that subpart F income derived from a wholly-owned subsidiary was qualifying income was not dependent on whether such subpart F income was distributed. Thus, although under the RIC CFC Dividend Rule under §851(b), currently distributed subpart F income generally is treated as a dividend for purposes of §851(b)(2), the PLRs also included undistributed subpart F income of the CFC subsidiary that was included in the RIC's income as qualifying "other income" under §851(b)(2).

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<sup>14</sup> Reg. §1.851-2(b)(2).

<sup>15</sup> PLR 200647017. See also PLRs 200741004, 200743005, 200822010, 200840039, and 200842014.

<sup>16</sup> PLR 200647017. See also PLRs 200741004, 200743005, 200822010, 200840039, and 200842014.

<sup>17</sup> PLRs 200912003, 200922010, 200923011, 200931003, 200931008, 200932007, 200936002, 200939017, 200946036, 200947032, 200947026, 201005023, 201007044, 201020003, 201024004, 201024003, 201025031, 201026017, 201030004, 201034011, 201037014, 201037012, 201039002, 201041033, 201042015, 201042001, 201043017, 201048022, 201048021, 201049015, 201051014, 201102055, 201102047, 201103009, 201103033, 201103017, 201104013, 201107012, 201108008, 201108018, 201116014, 201120017, 201122012, 201128022, 201129002, 201131001, 201132008, and 201134014.

The IRS also issued PLRs which included inclusions from PFIC QEFs as qualifying RIC income.<sup>18</sup>

*Comment:* As discussed below, the Proposed Regulations would, after the effective date of the final regulations, in effect overrule the prior PLRs involving CFCs and PFIC QEFs, under §851(b) and instead require distributions of CFC and PFIC QEF earnings in order to result in qualifying income.

#### **4. Suspension of Issuing Private Letter Rulings and Subsequent Developments**

The original version of the Regulated Investment Company Modernization Act would have amended §851(b)(2) to include income and gains from commodities as qualifying income.<sup>19</sup> This provision was not included in the final adopted legislation.

In July 2011, the IRS suspended the issuance of PLRs relating to CLNs and the issuance of PLRs relating to indirect investments in commodities through a wholly-owned CFC was also suspended.<sup>20</sup> At the time of such suspensions, the IRS did not revoke previously issued PLRs or issue negative guidance.

In December 2011, Senators Carl Levin and Tom Coburn sent a joint letter to the Commissioner of the IRS, Douglas H. Shulman, in which they asked the IRS to permanently suspend the issuance of the PLRs relating to indirect RIC investments in commodities.<sup>21</sup> In addition, on January 26, 2012, the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations held a hearing relating to the issuance of the PLRs involving wholly-owned offshore subsidiaries of RICs investing in commodities and PLRs related to investments by RICs in CLNs. Senator Levin reiterated his view that the conclusions in the PLRs were incorrect and he urged the IRS not to issue further rulings.<sup>22</sup>

### **C. The Revenue Procedure**

For purposes of the income test and the asset diversification requirements, an asset is a security if it is a security under §2(a)(36) of the 1940 Act. In accordance with the preamble of the Proposed Regulations, IRS has issued the Revenue Procedure, which provided that the IRS will not ordinarily issue a private letter ruling or determination letter involving any issue relating to the treatment as a RIC under §851 of the Code, and related provisions, that requires a determination whether a financial instrument or position is a security as defined in the 1940 Act. Although, the Revenue Procedure's "no ruling" policy is intended to apply to certain CLNs, it applies to the treatment of any investment by a RIC that would require a determination of as to whether the investment is a security, as defined in the 1940 Act. The Revenue Procedure is applicable to all requests for letter rulings, including any requests pending in the IRS National Office and any requests submitted on or after September 27, 2016.

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<sup>18</sup> PLRs 200743005, 200946036, 201039002 and PLR 201043033.

<sup>19</sup> H.R. 4337, 111<sup>th</sup> Cong., 1st Sess. (2009).

<sup>20</sup> Sheppard, *News Analysis: IRS Suspends RIC Commodities Investments Rulings*, 2011 Tax Notes Today 145-1 (July 28, 2011).

<sup>21</sup> 2012 Tax Notes Today 17-31.

<sup>22</sup> See *Compliance With Tax Limits on Mutual Fund Commodity Speculation*, Senate Hearing 112-343 (Jan. 26, 2012).

## D. The Proposed Regulations

The income test and asset diversification requirements applicable to RICs both use the term “securities.” For purposes of the qualifying income test, a security is defined by reference to §2(a)(36) of the 1940 Act. While §851(c) provides rules and definitions that apply for purposes of the asset diversification requirements of §851(b)(3) but does not specifically define “security.” Section 851(c)(6), however, provides that the terms used in §§851(b)(3) and (c) have the same meaning as when used in the 1940 Act. An asset is therefore a security for purposes of the income test and the asset diversification requirements if it is a security under the 1940 Act.

The preamble to the Proposed Regulations notes that the Treasury Department and the IRS have in the past previously addressed whether specific instruments or positions are securities for purposes of §851. However, the Proposed Regulations provide that the IRS will not ordinarily issue further rulings that depend on whether an instrument is a security under §2(a)(36) of the 1940 Act because it concludes that the determination of an investment is a security within the meaning of the 1940 Act “is . . . within the jurisdiction of the SEC.” As discussed above, the IRS also simultaneously issued the Revenue Procedure.

The Proposed Regulations also provide that income inclusions under §951 (for CFCs) and under §1293 (for PFIC QEFs) will be treated as dividends for purposes of §851(b)(2) only if distributions are made that are attributable to those inclusions. In addition, the Proposed Regulations provide that an inclusion under §§951(a)(1) or 1293(a) does not qualify as other income derived from a RIC’s business of investing in stock, securities, or currencies which means that a CFC or PFIC QEF inclusion would not qualify under the “other income” clause in §851(b)(2).

*Comment:* The proposed treatment of PFICs subject to a QEF election would be problematic to RICs that may not have the ability to control distributions by the PFIC. It could also be particularly problematic if the CFC or PFIC in which the RIC invests has taxable income in excess of cash available for distribution.

The rule in the Proposed Regulations applies to taxable years that begin on or after the date that is 90 days after the date of publication in the Federal Register of a Treasury decision adopting the Proposed Regulations as final regulations.

Before the Proposed Regulations are adopted as final regulations, consideration will be given to any comments that are submitted to the IRS by December 27, 2016. The Treasury Department and the IRS also request comments as to whether Rev. Rul. 2006-1, Rev. Rul. 2006-31, and other previously issued guidance that involves determinations of whether a financial instrument or position held by a RIC is a security under the 1940 Act should be withdrawn effective as of the date of publication in the Federal Register of a Treasury decision adopting the Proposed Regulations as final regulations.

*Comment:* The withdrawal of the prior Revenue Rulings and other previously issued guidance could potentially have an effect on the treatment of other types of investments under the qualifying income requirement.



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