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Federal Tax Guidance Regarding RICs' Investments in Commodities, Certain PFICs, and "Securities"

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Introduction

The Treasury Department (**Treasury**) and the Internal Revenue Service (**Service**) recently issued proposed regulations that, if finalized as proposed, could have a significantly adverse effect on the ability of a regulated investment company (**RIC**) to indirectly invest in commodities through a subsidiary. Contemporaneously, the Service issued a revenue procedure (**Revenue Procedure**) that also could have such an effect on "structured notes."

Background

The Service concluded in Revenue Ruling 2006-1 that derivative contracts providing for a total return exposure to a commodity index are not "securities" for purposes of section 851(b)(2)¹ and do not produce "qualifying income" for a RIC. Beginning shortly thereafter, numerous RICs indirectly invested in commodities through wholly owned offshore subsidiaries (known as "controlled foreign corporations" (**CFCs**) under the Code)—the income from which for a taxable year must be included in the RIC shareholder's gross income (a so-called "**subpart F inclusion**")—which the Service effectively endorsed by issuing over 40 private letter rulings (**PLRs**) (through 2011) holding that a RIC's inclusion of that income is qualifying income.²

RICs' investments in CFCs for purposes of indirectly investing in commodities have become endangered as a result of newly proposed regulations under the Code (**Proposed Regulations**) published on September 28, 2016. Under the Proposed Regulations, inclusions of a CFC's income, as well as income of a passive foreign investment company that is a "qualified electing fund" (**QEF**), in a RIC's income will no longer be considered qualifying income for the RIC unless the CFC or QEF also makes distributions to the RIC out of the associated earnings and profits for the applicable taxable year. Although many RICs currently do receive annual distributions from their wholly owned CFCs, RICs that do not—and RICs that have investments in QEFs (which generally do not make annual distributions)—might have difficulty in one or more taxable years satisfying the Income Requirement (see below).

Contemporaneously with the publication of the Proposed Regulations, the Service issued Revenue Procedure 2016-50, which provides that the Service will not ordinarily issue rulings or determination letters on any issue relating to the treatment of a corporation as a RIC that requires a determination of whether a financial instrument or position is a "security."

¹ "Section" references are to the Internal Revenue Code of 1986, as amended (**Code**), unless otherwise noted.

² During the same period, the Service also issued numerous PLRs concluding that income from certain commodity-linked structured notes is qualifying income because the notes meet the definition of "securities."

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Accordingly, the issuance of PLRs addressing the status of commodity-linked structured notes is not expected to resume.

The Proposed Regulations

In defining the term "regulated investment company," section 851(b)(2) provides, in relevant part, that "[a] corporation shall not be considered a [RIC] for any taxable year unless ... at least 90 percent of its gross income is derived from — (A) dividends ... and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended [**1940 Act**] ...) , 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 ...*" (the italicized portion being referred to herein as **Other Income**) (**Income Requirement**). Other language in section 851(b) provides, in relevant part, that, for purposes of section 851(b)(2), subpart F and QEF inclusions for a taxable year will be treated as dividends to the extent that, under the Code sections dealing with the inclusions, there is a distribution out of the CFC's or QEF's earnings and profits of the taxable year that are attributable to the amounts so included.

Based on that language, the Proposed Regulations would reverse the determinations the Service made in the PLRs. Specifically, the Proposed Regulations would provide that subpart F inclusions from a CFC and inclusions from a QEF will not be qualifying income for a RIC unless accompanied by the CFC's or QEF's distribution of the earnings and profits of the taxable year that are attributable to the inclusions. The Proposed Regulations also specifically provide that subpart F and QEF inclusions will not be treated as Other Income, effective for taxable years that begin on or after the date that is 90 days after the date of the publication of final regulations. Accordingly, after that date, any RIC that has a CFC or QEF inclusion in any taxable year can be assured of its being characterized as qualifying income only if it satisfies the applicable distribution requirement.

The Revenue Procedure

The preamble to the Proposed Regulations notes that, in addition to having to satisfy the Income Requirement, a corporation also must satisfy a diversification requirement to qualify as a RIC. A crucial part of the latter involves "securities." As noted above, the Code section containing the Income Requirement expressly incorporates the definition of "securities" in the 1940 Act. The preamble devotes a significant amount of analysis to the foregoing and concludes that "[a]ny future guidance regarding whether particular financial instruments, including investments that provide RICs with commodity exposure, are securities for purposes of the 1940 Act is therefore within the jurisdiction of the [Securities and Exchange Commission]."

That conclusion is being implemented in the Revenue Procedure, by amendment of a revenue procedure that the Service issues annually, shortly before the beginning of each year (for this year, Revenue Procedure 2016-3), identifying, in section 4 thereof, "Areas In Which Rulings Or Determination Letters Will Not Ordinarily Be Issued." As pointed out in the Revenue Procedure, "[n]ot ordinarily' means that unique and compelling reasons must be demonstrated to justify the issuance of a letter ruling or determination letter." The specific amendment by the Revenue Procedure provides that Revenue Procedure 2016-3 "is supplemented by adding a new paragraph (63) to section 4.01 to read as follows:

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(63) Section 851.—Definition of Regulated Investment Company.—Any issue relating to the treatment of a corporation as a regulated investment company under section 851 and related provisions that requires a determination whether a financial instrument or position is a security as defined in the [1940 Act].”

Note that the Revenue Procedure added that provision to section 4 of Revenue Procedure 2016-3 rather than to section 3 thereof, which is entitled “Areas In Which Rulings Or Determination Letters Will Not Be Issued” (i.e., it omits the word “Ordinarily”). Accordingly, supplementing section 4 rather than section 3 suggests that the Service might be willing to issue a PLR involving that issue under “unique and compelling” circumstances.

The Revenue Procedure is effective immediately (i.e., it “applies to all requests for [PLRs], including any requests pending in the national office and any requests submitted on or after September 27, 2016”).

Comments Requested

The Treasury and the Service requested comments, by December 27, 2016, “on the clarity of the proposed regulations and how they can be made easier to understand,” and announced that they will hold a hearing on them if a written request therefor is made by that date. The preamble also requested comments as to whether Revenue Ruling 2006-1, Revenue Ruling 2006-31 (which modified the former), 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 of final regulations.

This presents an important opportunity to ensure that the Treasury and the Service are made aware of business practices, fact patterns, and other information that may be relevant as they finalize the regulations and decide whether to withdraw prior guidance. Interested stakeholders should evaluate how the Proposed Regulations and such a withdrawal may affect their operations to determine whether to provide comments. The K&L Gates team is available to answer any specific questions you may have and is prepared to assist you with the submission of comments.

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