

*By Electronic Delivery*

August 18, 2011

Stephen Larson  
Associate Chief Counsel (Financial Institutions and Products)  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington DC

RE: *Suspension of Rulings to RICs Seeking  
Commodities Exposure*

Dear Steve:

Thank you very much for meeting with the Investment Company Institute<sup>1</sup> and several practitioners last week to discuss the recent suspension of the private letter rulings process for regulated investment companies (“RICs”) seeking commodities exposure (hereafter, “the rulings process”). As we emphasized, substantial competitive pressures have been building since the industry learned of the suspension. These pressures result from the disruption of settled expectations, the newly un-leveled playing field, and concerns (based in part on the lack of a public explanation for the suspension) regarding the Service’s continuing comfort with the legal analysis underpinning the 70-plus private letter rulings that have been issued.

We urge the Service to restart the rulings process immediately. The industry will draw no inference from a decision to restart the rulings process while the Service evaluates its approach to these issues.

We also urge the Service to issue published guidance based upon these rulings; this guidance would benefit both the Service and the industry. Enclosed for your consideration is a draft revenue procedure on the controlled foreign corporation (“CFC”) approach for gaining commodities exposure. We will send to you soon a draft revenue procedure on the commodity-linked note (“CLN”) approach

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.1 trillion and serve over 90 million shareholders.

for gaining commodities exposure. Because of the time required to issue published guidance, it is imperative that private letter rulings be issued in the interim.

### Industry Concerns

The industry learned of the rulings process suspension when practitioners with pending ruling requests were told that expected rulings were put on hold. This development was totally unexpected; the practitioners had been led to believe that the rulings – which would be virtually identical to the rulings issued over the past five years – would be issued in a matter of days or weeks. In some instances, new funds were launched based on the expectation that their rulings were about to be issued. The Service's abrupt suspension of the rulings process disrupted settled expectations and has caused great consternation in the industry.

The suspension also has created a competitive distortion. Over the past several years, RICs with commodity exposure through CFCs or CLNs have become an established part of the investment marketplace. These RICs typically either received private letter rulings or opinions of counsel (which were based, in part, on the numerous private letter rulings that have been issued). New entrants to this market with pending ruling requests are now stymied, and counsel are reluctant to issue opinions given the Service's decision to suspend the rulings process without public explanation.

We understand that the Service's decision to suspend the rulings process is attributable, at least in part, to the fact that the Commodity Futures Trading Commission ("CFTC") is reconsidering its regulatory approach to RICs that have substantial commodities exposure. As we discussed, the fact that another Federal agency – applying its own policies and rules – may determine that a RIC or a RIC's subsidiary is subject to regulation by that agency has no bearing on the tax analysis relating to the CFC or CLN approaches.<sup>2</sup>

We also understand that the Service's decision may be attributable, in part, to a change to the RIC Modernization legislation and, possibly, a Treasury letter from 1986 regarding proposed amendments to the RIC qualification tests. As we explained, the deletion of the commodity income provision from the RIC Modernization legislation was a consequence of the procedures under which the legislation was considered by the House of Representatives and the Senate. The legislation was enacted as one of the last acts of the 111<sup>th</sup> Congress in December 2010 under procedures that required unanimous consent. The House of Representatives unanimously approved legislation that included a provision to allow RICs to have unlimited direct investments in commodities. When a few Senators

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<sup>2</sup> For example, if a RIC were to own a subsidiary that operated an airline, which the tax laws clearly permit, the Federal Aviation Administration would regulate the subsidiary. Similarly, if a RIC owned a subsidiary that was a bank, the Office of the Comptroller of the Currency would regulate the subsidiary, and the RIC would be regulated as a bank holding company. In neither case would the tax status of the RIC be affected so long as the subsidiary's value did not exceed 25 percent of the value of the RIC's assets.

raised certain concerns about expanding a RIC's ability to gain commodities exposure, the provision was dropped to ensure end-of-year passage of the rest of the legislation. The deletion was not an expression of broad Congressional opposition to amending Subchapter M to permit RICs to have direct exposure to commodities.

Similarly, the 1986 letter from Treasury Department Acting Assistant Secretary Mentz did not suggest that RICs are precluded from gaining commodities exposure indirectly through investments in stock and securities. Instead, the letter merely stated the obvious: funds cannot invest *directly* in commodities, just like they cannot *operate* a trade or business, and generate qualifying income.<sup>3</sup> The letter in no way suggested that income from an investment in a subsidiary that operates a trade or business or engages in commodities transactions somehow is inappropriate for RICs.

Financial advisers today, following modern portfolio theory, encourage clients to diversify across a broad range of asset classes; the range of potential investments includes stocks, bonds and commodities. No tax policy exists that would prevent RIC investors from gaining indirect exposure to commodities.

### Tax Analysis

The tax analysis of both the CFC and CLN approaches, in our view, is straightforward. We see no basis for concluding that a RIC's income from investments in a CFC or a properly structured CLN is anything other than qualifying income under section 851(b)(2).

#### CFCs

Qualifying income under section 851(b)(2) includes income from investments in stock and securities. Stock of a CFC is plainly "stock" within the meaning of section 851(b)(2).<sup>4</sup> The fact that

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<sup>3</sup> Assistant Secretary Mentz' letter stated (among other things):

H.R. 3397 would amend section 851(b)(2) to expand the list of qualifying income . . . . 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, . . . we would generally not treat as qualifying income gains from trading in commodities . . . .

Letter from Treasury Department Acting Assistant Secretary Roger Mentz to The Honorable Ronnie G. Flippo, pp. 4-5, dated February 5, 1986.

<sup>4</sup> The stock also is stock for subpart F purposes. Note that the 1986 amendment that defines "securities" as used in section 851(b)(2) by reference to section 2(a)(36) of the Investment Company Act of 1940 does not apply to the meaning of the term "stock." *See, e.g.*, Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at

the RIC owns 100 percent of the CFC's stock has no impact on the analysis. First, section 851(b) contemplates that a RIC can have one or more wholly-owned subsidiaries.<sup>5</sup> Second, section 851(b) contemplates that RICs will invest in CFCs.<sup>6</sup>

The fact that the CFC engages in commodity-related transactions also has no bearing on the analysis. While it is true that the commodity-related income of the CFC would not be qualifying income if earned directly by the RIC, the same would be true if the CFC earned income from engaging in any number of active businesses (*e.g.*, operating a pants factory, running a janitorial service, operating an airline, etc.). From a Subchapter M perspective, there is nothing different about a RIC investing in a CFC that engages in commodities transactions than there is about a RIC investing in a CFC engaged in one or more active businesses.

The conclusion that Congress is comfortable with a RIC's ability to gain exposure to commodities through investments in other entities is demonstrated by legislation enacted in 2004 permitting a RIC to receive qualifying income from investments in "qualified publicly traded partnerships" ("QPTPs").<sup>7</sup> These QPTPs may be organized with the principal purpose of buying and selling commodities or commodity derivatives.<sup>8</sup>

Finally, the fact that a RIC gains exposure to commodities through investment in a CFC is not merely a matter of form. Because the RIC's investment is in the stock of the CFC, the RIC cannot lose more than the amount of its investment.

We believe that the analysis of the CFC approach is sufficiently straightforward and the factual variations sufficiently minimal that published guidance can and should be issued expeditiously. We have drafted language for a revenue procedure along these lines. A copy is enclosed for your reference.

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page 382 ("The Act provides a definition of 'securities' in section 851(b)(2) by reference to the definition of securities in the Investment Company Act of 1940 . . .").

<sup>5</sup> See section 851(b)(3), which permits a RIC to have up to 25 percent of its assets invested in one company without any limitation on the percentage of ownership of the company the RIC holds.

<sup>6</sup> See the flush language of section 851(b) regarding the treatment of subpart F inclusions under section 951(a).

<sup>7</sup> See section 851(b)(2)(B). The fact that the version of RIC Modernization legislation that would have allowed RICs to have unlimited direct exposure to commodities was unable to receive unanimous consent in the Senate is not indicative of any contrary legislative intent.

<sup>8</sup> See Code section 7704(d)(1)(G).

CLNs

The tax analysis of CLNs also is straightforward. Qualifying income under section 851(b)(2) includes income from “securities” as defined in section 2(a)(36) of the Investment Company Act of 1940.<sup>9</sup> Thus, if a particular CLN falls within this definition, the income from that CLN is qualifying income.<sup>10</sup> We recognize that there is no established bright-line test for determining whether a CLN falls inside or outside this definition. Nevertheless, we believe that the factors that should be used in determining whether a CLN properly is treated as a security can be identified easily and articulated clearly in published guidance. We will discuss these factors when we submit our draft language for a revenue procedure on the CLN approach for gaining commodities exposure.

Conclusion

The ICI urges the Service to resume issuing private letter rulings on the CFC and CLN approaches without delay. The suspension of the rulings process has upset settled expectations and created competitive distortions in the fund industry.

We also urge published guidance on the CFC and CLN approaches; this guidance would reduce substantially the number of private letter ruling requests that the Service receives. The draft revenue procedure we enclose on the CFC approach, in our view, responds fully to all of the issues discussed at our meeting. We are ready and willing to work with the Service and the Treasury Department as you develop published guidance in this area.

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<sup>9</sup> 15 U.S.C. §§ 80a-1 *et seq.*

<sup>10</sup> Rev. Rul. 2006-31 expressly recognized that a properly structured CLN can give rise to qualifying income under section 851(b)(2).

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Please feel free to contact me at any point regarding this issue, this letter, or the attached draft guidance. We will follow up with you soon. Once again, thank you for the time that you and your colleagues have spent with us discussing this critically important issue.

Sincerely,

*/s/ Keith Lawson*

Keith Lawson  
Senior Counsel – Tax Law

Enclosure

cc: David Silber  
Susan Baker  
Cathy Fung

Rev. Proc. 2011-\_\_\_\_\_

**1. Purpose**

This revenue procedure provides guidance for regulated investment companies (“RICs”) regarding the application of section 851(b)(2) to income included under section 951(a) in respect of stock of a controlled foreign corporation that engages in transactions in commodities (including commodities derivatives such as options, futures and swaps on commodities).

**2. Background**

.01. Section 851(b)(2) provides 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 certain specified sources (“qualifying income”). Qualifying income under section 851(b)(2) includes “dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), 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) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [the RIC’s] business of investing in such stock, securities, or currencies.”

.02. Section 957 defines a controlled foreign corporation (“CFC”) as any foreign corporation in which more than 50 percent of (1) the total combined voting power of all classes of stock entitled to vote, or (2) the total value of the stock is owned by United States shareholders on any day during the corporation’s taxable year. A United States shareholder is defined in section 951(b) as a United States person who owns 10 percent or more of the total voting power of a foreign corporation.

.03. Section 951(a)(1) provides that if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder of such corporation and who owns stock in such corporation on the last day of the taxable year shall include in gross income the shareholder’s pro rata share of the CFC’s subpart F income for the taxable year.

.04. Section 952(a)(2) defines subpart F income to include foreign base company income determined under section 954. Under section 954(a)(1), foreign base company income includes foreign personal holding company income determined under section 954(c). Under section 954(c)(1), foreign personal holding company income includes: (i) gains in excess of losses from transactions in commodities, including futures, forward, and similar transactions, but excluding certain hedging transactions and certain active business gains and losses; and (ii) subject to certain exceptions, net income from notional principal contracts.

.05. Section 851(b) provides that for purposes of section 851(b)(2), there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A)(i) for the taxable year to the extent that, under section 959(a)(1), there are distributions out of the earnings and profits of the taxable year that are attributable to the amounts so included.

.06. A RIC wishing to gain exposure to commodities may form a foreign subsidiary that engages in commodity-related transactions (including entering into commodity-related derivatives such as futures, options and swaps). If the subsidiary is a corporation for U.S. income tax purposes, the subsidiary is a CFC within the meaning of section 957 and the RIC is a United States shareholder within the meaning of section 951(b). The subsidiary's commodity-related transactions may generate foreign personal holding company income under section 954(c), which the RIC will include in its income pursuant to section 951(a).

### **3. Scope**

.01. This revenue procedure applies to a RIC that is a United States shareholder of a CFC that meets the requirements of this section.

.02. A CFC meets the requirements of this section if it complies with the requirements of section 18(f) of the Investment Company Act of 1940 as amended (the "1940 Act"), Investment Company Act Release No. 10666, and related guidance of the Securities and Exchange Commission pertaining to asset coverage.

### **4. Procedure**

In the case of a RIC to which this revenue procedure applies, subpart F inclusions of income under section 951(a) attributable to commodities transactions (including commodities derivatives such as options, futures and swaps) of a CFC that meets the requirements of section 3 constitute income derived with respect to the RIC's business of investing in stock and securities within the meaning of section 851(b)(2).

### **5. Drafting Information**

The principal author of this revenue procedure is \_\_\_\_\_ of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information, contact [him/her] at (202) 622-\_\_\_\_\_ (not a toll-free call).