Part I

Section 851.—Definition of Regulated Investment Company

26 CFR 1.851–2: Limitations
(Also Sections 7704, 7805; 301.7805–1)

Rev. Rul. 2006–1

ISSUE

If a corporation enters into a derivative contract that provides for a total-return exposure on a commodity index, does income from the derivative contract satisfy the test described in section 851(b)(2) of the Internal Revenue Code?

FACTS

R is a management company registered under the Investment Company Act of 1940 (the "'40 Act"), 15 U.S.C. section 80a–1 et seq., as amended, and has elected under section 851(b)(1) of the Code to be a regulated investment company (RIC) taxable under subchapter M, part I, of the Code. R invests substantially all of the funds it receives from shareholders in debt instruments. R also enters into contracts ("Derivatives") with various counterparties pursuant to Master Agreements under which it will pay an amount equal to the 3–month U.S. Treasury bill rate plus a spread and pursuant to which it will receive (or pay) an amount based on the total return gain (or loss) on a commodity index. The aggregate amount of the index on which the return on the Derivatives is based is approximately equal to the aggregate amount R has invested in its debt instruments. The payment obligation on each Derivative is settled monthly by the receipt (in the event of a gain) or payment (in the event of a loss) of cash, in the net amount due under the contract, and each monthly measuring period constitutes a separate derivative contract under the Master Agreements.

LAW

Section 851(b)(2) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an income test (the "qualifying income requirement"). Under this test, at least 90 percent of its gross income must be derived from certain enumerated sources.

In addition, section 851(b)(3) of the Code provides that a corporation shall not be considered a RIC for any taxable year unless it meets an asset test (the “asset test”). Under this test, at least 50 percent of its total assets must be represented by cash, cash items, Government securities, securities of other RICs, and “other securities.” The “other securities” are generally limited with respect to any one issuer to an amount not greater than 5 percent of the value of the RIC’s total assets and to not more than 10 percent of the outstanding voting securities of the issuer.

Prior to the enactment of the Tax Reform Act of 1986 (the “1986 Act”), section 851(b)(2) identified qualifying income as “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.” Section 851 did not contain its own definition of the term “securities,” but section 851(c)(5) provided that, for purposes of the asset test, “all other terms shall have the same meaning as when used” in the ’40 Act.

The 1986 Act expanded the definition of RIC qualifying income in a number of ways: by adding a cross-reference to the definition of “securities” in the ’40 Act; by adding gains from the sale or other disposition of foreign currencies; and by adding an “other income” provision. As so amended, section 851(b)(2) defines qualifying income, in relevant part, as—

> 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 [the ’40 Act]) 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 . . . .

Section 851(b) further provides that, for this purpose, “the Secretary may by regulation exclude from qualifying income foreign currency gains which are not directly related to the company’s principal business of investing in stock or securities (or options and futures with respect to stock or securities).”

The ’40 Act defines “security” as—

> any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a

national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 80a–2(a)(36) (2000).

ANALYSIS

1. Definition of "securities."

The Derivatives that R enters into are not stock, debt instruments, or currency (or options, futures, or forward contracts with respect to stock, debt instruments, or currency). Nevertheless, R's income from the Derivatives may be "other income" if the Derivatives are "securities" for purposes of section 851(b)(2). This determination depends on the effect of the 1986 Act amendments to section 851(b)(2), which added the cross-reference to the definition of securities in the '40 Act.

There is no conclusive authority, however, as to whether derivative contracts on commodities are included in the '40 Act's definition of "securities." Accordingly, consideration of Congressional intent in enacting that cross-reference is helpful in determining whether commodity derivative contracts are securities for purposes of section 851(b)(2). Evidence of that intent may be found in the background to amendments to section 851(b)(2) in the 1986 Act. The amendments were added as a Senate floor amendment to the bill that eventually became the 1986 Act. The House and Senate committee reports, therefore, do not discuss these provisions, and the relevant discussion of the cross-reference in the report of the Conference Committee is extremely brief. See H.R. Rep. No. 99–426 (1985) (not discussed); S. Rep. No. 99–313 (1986) (not discussed); 2 H.R. Conf. Rep. No. 99–841, at II–243 (1986) ("The Senate amendment clarifies the definition of 'securities' by reference to the definition of securities in the Investment Company Act of 1940.") Thus the best evidence of Congressional intent is found in the floor statement when the provision was added to the Senate bill and in other floor statements and Administration comments concerning related legislation.

The legislative antecedents to the 1986 Act amendments included H.R. 3397, which was introduced on September 20, 1985, by Representatives Flippo, Kennelly, and McGrath, and S. 2155, which was introduced on March 7, 1986, by Senator Armstrong. These bills proposed the "other income" provision and the cross-reference to the definition of security in the '40 Act. The former change was to codify a series of letter rulings, and the latter was to reflect then-current Treasury Regulations. See 131 Cong. Rec. 24,570 (1985) (section-by section analysis of H.R. 3397).

With respect to the definition of qualifying income, Senator Armstrong's floor amendment to the bill that became the 1986 Act was identical to S. 2155. In introducing S. 2155, Senator Armstrong explained that his bill incorporated "minor changes" to H.R. 3397 "to comply with recommendations of the Treasury Department, which has given its support for the Bill." 132 Cong. Rec. 4045 (1986) (remarks of Senator Armstrong). Senator Armstrong concluded his remarks by inserting into the Congressional Record the letter from the Treasury Department that had recommended changes to H.R 3397. See id. at 4046, 4047–48 (inserting a letter from Acting Assistant Secretary of the Treasury (Tax Policy) J. Roger Mentz, dated February 5, 1986).

Mr. Mentz's letter explained the fundamental policy served by the qualifying income requirement:

> [I]t 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 that 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.

Id. at 4048.

The letter pointed out that the Service had "often gone beyond the literal terms of the statute in order to give a reasonable interpretation to [then-current] section 851(b)(2)," for example by granting letter rulings that certain investment products were securities, gains on the sale or disposition of which resulted in qualifying income. (The products explicitly mentioned were options on securities, futures contracts on securities, stock index futures, options on stock indices, and options on stock index futures.) The letter noted that, despite this flexibility, each RIC could be certain of the treatment of various income items only by obtaining its own letter ruling. See id. at 4047–48. Thus, one justification for the amendments in H.R. 3397 appeared to be providing the needed certainty.

With respect to foreign currency gains, the Treasury letter stated:

> We believe that investments in foreign-currency denominated securities are the type of passive investments that should be permissible for RICs. Moreover, foreign currency investments that are made to hedge investments in foreign-currency denominated securities also appear to be an appropriate[] part of the passive investment activity of RICs. Accordingly, we believe that foreign currency gains from investments in foreign-

> currency denominated securities and from hedging activities with respect to such securities should be treated as qualifying income under section 851(b)(2).

Id. at 4048.

The Treasury Department, however, was not prepared at that time to propose statutory rules that would distinguish between currency gains relating to investments in stocks or securities denominated in a foreign currency and other currency gains that Treasury believed should not be qualifying income under section 851(b)(2). The letter, therefore, suggested that foreign currency gains be added to the list of qualifying income but that Treasury be provided with "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." Id.

When Senator Armstrong offered the relevant provision as an amendment on the Senate floor, he asserted that it "enjoys the support of the Treasury Department" and that its purpose was "to permit the mutual fund industry to make better use of income from stock options, futures contracts and options on stock ind[ic]es, options and futures o[n] foreign currencies, and foreign currency transactions." 132 Cong. Rec. 14,991-92 (1986).

This discussion demonstrates that the amendments to section 851(b)(2) made by the 1986 Act had a very specific purpose, which was to provide certainty by expanding the statutory description of qualifying income to include income that the Service, in specific cases, had already treated administratively as qualifying income. This included income from derivative contracts on stocks and securities (as the term "security" is generally understood in the U.S. tax law), such as futures and options on stock indices, which create an economic exposure to stock or securities even though the property underlying the derivative may be a collection of stocks and securities, rather than a specific stock or security.

The new rule regarding gains from foreign currencies (and options, futures or forward contracts on foreign currencies) was distinct from both the "other income" provision and the cross-reference to the definition of "security" in the '40 Act. Thus a separate provision both established the general rule that foreign currency gain is qualifying income and created specific regulatory authority to exclude any foreign currency gains that are not "directly related" to a RIC's "principal business of investing in stock or securities (or options and futures with respect to stock or securities)." The reason was that these gains were income from property other than stock or securities.

The foregoing indicates 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.” Particularly important was the specific inclusion in the 1986 amendment of foreign-currency-related gains. If the ’40 Act were read expansively, there would be no need for special mention of these gains, because they would be included in the provision for “other income . . . derived with respect to [the RIC’s] business of investing in securities.” Moreover, the authority given to Treasury to exclude from qualifying income “foreign currency gains which are not directly related to the company’s principal business of investing in stock or securities” indicates that the reason for the special treatment for foreign currency was to facilitate a RIC’s principal activity, namely investing in qualifying stock or securities, when the stock or securities are denominated in a foreign currency.

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 in amending section 851(b)(2) in 1986. Accordingly, because the underlying property is a commodity (or commodity index), the Derivatives that R enters into are not securities for purposes of section 851(b)(2).

2. Application of the “other income” provision.

R invests substantially all of the funds it receives from shareholders in debt instruments, which are securities for purposes of section 851(b)(2). Even though R’s Derivatives are not themselves securities for purposes of section 851(b)(2), income from the Derivatives counts toward the 90–percent test if it is “other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to [R’s] business of investing in” stock, securities, or currencies.

R, however, does not enter into the Derivatives in connection with a business of investing in stock, securities, or currencies. Nor does R enter into the Derivatives in order to reduce or hedge the level of risk in a business of investing in stock, securities, or currencies. R’s business is to create investment exposure to changes in commodity prices, and the Derivatives are the primary vehicle for doing so. R owns the debt instruments to facilitate its business of providing this commodity-derivative exposure. Because R’s Derivatives are not themselves securities and because R 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).

HOLDING

A derivative contract with respect to a commodity index is not a security for purposes of section 851(b)(2). Under the facts above, R’s income from such a contract is not qualifying income for purposes of section 851(b)(2) because the income from the contract is not derived with respect to R’s business of investing in stocks, securities or currencies.

PROSPECTIVE APPLICATION

Under the authority of section 7805(b)(8), the holding of this revenue ruling will not be applied adversely with respect to amounts of income that a taxpayer recognizes on or before June 30, 2006.

DRAFTING INFORMATION

The principal author of this revenue ruling is Dale S. Collinson of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling contact him at (202) 622-3900 or Susan Thompson Baker at (202) 622-3930 (not toll-free calls).