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The IRS's Stricter(?) Stance on Regulated Investment Company Investments in Commodities

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While the IRS's Proposed Regulations Are Not Yet Effective, RICs Should Carefully Consider Whether Their Portfolios or Policies Run Afoul of the New Rules.

In order for a corporation to qualify as a regulated investment company (RIC), it must derive 90 percent of its gross income for each taxable year from certain categories of qualifying income, including dividends, interest, gain from the sale of stock or securities and certain other income (Qualifying Income). The "other income" category is limited to "other income . . . derived with respect to [the RIC's] business of investing in such stock, securities, or currencies."[1] Generally, commodity income received directly by a RIC is not considered Qualifying Income for RIC qualification purposes. Due to the limitations on investments that produce non-Qualifying Income, fund managers deploy specific strategies to gain exposure to those investments. New proposed regulations seek to limit the strategies employed to gain exposure to commodity investments.

Direct Investments by a RIC in the Commodities Market

Commodity income received directly by a RIC generally is not Qualifying Income (*i.e.,* it is a "bad" investment for RIC qualification purposes). In December 2005, the IRS specifically ruled that a derivative contract with respect to a commodity index was not a security and, thus, did not produce "other income."[2] However, the IRS backtracked six months later, when it clarified the earlier ruling, limiting it to a total return swap on a commodity index.[3] This left open the possibility that certain structured notes that were treated as securities could produce Qualifying Income, while providing limited exposure to commodity returns. The IRS confirmed in a series of private letter rulings between 2006 and 2011 that income and gain from certain structured notes where the interest income was tied to a commodity index was "other income" from a security and, thus, Qualifying Income.

In order to gain additional exposure to the commodity markets beyond notes paying interest based, in part, on a commodities index, RICs began investing in foreign corporations classified as controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs) that invested in commodities. To understand the changes in the proposed regulations that affect these investments, a brief overview of the taxation of CFCs and PFICs is required.

Foreign Taxation of CFCs and PFICs – A Primer

Investments in certain foreign corporations require a U.S. investor to recognize income as it is earned by the

foreign corporation, regardless of whether it is distributed to the U.S. investor (deemed income). Deemed income arises in the context of a CFC and a PFIC.

A CFC is a foreign corporation in which U.S. investors, each holding 10 percent of the vote of the corporation, collectively hold more than 50 percent of the vote. These U.S. investors in the CFC must include certain types of income (referred to as Subpart F income) from the CFC, regardless of whether it is distributed. Subpart F income includes income from dividends, notional principal contracts and commodities. Thus, a RIC investing in a CFC that earned income relating to commodities investments would be required to include deemed income relating to these investments in income, even if there were no distributions from the CFC.

A PFIC is a foreign corporation where 75 percent or more of its gross income is passive and 50 percent or more of the average value of its gross assets consists of assets that would produce passive income. A PFIC's retained income is not taxed to a U.S. investor unless the investor makes a qualified electing fund (QEF) election. A U.S. investor who makes a QEF election with respect to a PFIC must take into account his pro rata share of the PFIC's ordinary earnings and net capital gain for each year the corporation is a PFIC, whether or not they are distributed.

Analysis of Indirect Investments by a RIC in the Commodities Market Through a CFC or PFIC Prior to Proposed Regulations

Before the proposed regulations were issued, there were two arguments that could apply to treating income from a CFC or a PFIC as Qualifying Income.

First, under the explicit "Matching Distribution Rule,"[4] taxpayers argued that dividends that are actually distributed from CFCs and PFICs are viewed as Qualifying Income because they constitute dividends. Thus, a RIC can gain exposure to the commodities market without the risk of non-Qualifying Income by forming a foreign subsidiary that invests directly in commodities investments and makes actual distributions equal to the deemed income of the CFC to the RIC.

Second, many taxpayers argued that the RIC's investment in the CFC or the PFIC is viewed as a security and, thus, any income from that security is "other income" derived with respect to securities, whether or not it was actually distributed. Accordingly, the deemed income from CFCs and PFICs, regardless of whether it is distributed to the RIC, should be Qualifying Income. Thus, a RIC could gain exposure to the commodities market through a foreign corporation without having to actually distribute cash to the RIC, allowing the RIC to have a greater deployment of funds and a greater return on investment. Because the position on whether deemed distributions constituted Qualifying Income was uncertain, many taxpayers sought and received IRS-issued private letter rulings between 2006 and 2011 that agreed with this analysis. These rulings held that the deemed income inclusion from a CFC was Qualifying Income, regardless of whether the CFC made distributions.[5]

Current Analysis of Exposure to the Commodities Market

By 2010, the IRS was "devoting substantial resources" to these private letter ruling requests.[6] Accordingly, in 2011, the IRS announced it would no longer issue private letter rulings as to whether certain commodity-related investments, either directly by a RIC or indirectly through foreign corporations, produced Qualifying Income.

In 2016, the IRS decided to address the strategies RICs were using to invest in commodities investments that created Qualifying Income — (1) investing directly in certain derivatives on the commodities index and (2) investing indirectly in commodities investments through certain foreign corporations.

In the proposed regulations, the IRS punted to the Securities and Exchange Commission (SEC) on whether direct investments in certain derivatives linked to a commodities index were securities (and, thus, produce "other income," which is Qualifying Income). As "security" is defined under section 2(a)(36) of the Investment Company Act of 1940, which is enforced by the SEC, the IRS concluded the SEC is in a better position to determine what qualifies as a security.[7] The IRS also asked for comments regarding whether its previous rulings on whether a RIC's direct investment in certain commodity derivatives qualify as a security should stand as good law.

For indirect investments in the commodities market through foreign corporations, the proposed regulations now explicitly require a distribution from a CFC or a PFIC in order for deemed income to be Qualifying Income. This is contrary to the IRS's prior private letter rulings position. Thus, the proposed regulations now provide that CFC or PFIC income is Qualifying Income only to the extent there is an actual distribution from the PFIC or the CFC to the RIC that qualifies under the Matching Distribution Rule. Deemed income without a corresponding distribution is no longer considered Qualifying Income under the "other income" category.

Pepper Perspective

While these proposed regulations are not effective until 90 days after they are finalized, RICs should carefully consider whether their portfolios or policies run afoul of the proposed regulations (*i.e.,* ensure all investments are classified as "securities" under the SEC's interpretation of the 1940 Act and ensure any CFCs or PFICs make actual distributions).

RICs may be surprised to learn that the SEC's definition of securities is not the same as the IRS's definition. RICs should seek counsel to ensure their investments qualify under the SEC's definition.

For RICs that invest in CFCs or PFICs and have deemed income inclusions, managers need to ensure there is a distribution from those CFCs or PFICs on or before the last day of the RIC's taxable year. There is no grace period, and RICs will have to rely on an estimate of their deemed income from such an investment. To the extent a RIC's estimate is too low, the "unmatched" inclusion will be non-Qualifying Income. Requiring a distribution may be difficult for certain RICs that are not in control of the CFC or the PFIC. These investments should be reconsidered prior to finalization of the proposed regulations.

In addition, RICs need to ensure that a distribution from a CFC or a PFIC will be respected. While no guidance from the IRS has been issued regarding mechanics for distributions, we do not believe that the IRS is likely to look kindly on netting a distribution from a CFC or a PFIC and recontributing to the CFC or the PFIC. Thus, if the RIC intends to re-invest the distribution in the CFC or the PFIC at a later date, the RIC should not use a netting concept by declaring a dividend and simultaneously recontributing that amount on the same day. We think the prudent course of action is to make an actual cash distribution of the funds from the foreign corporation and re-invest at a later point in time.

Endnotes

[1] Internal Rev. Code § 851(b)(2)(A).

[2] Rev. Rul. 2006-1.

[3] Rev. Rul. 2006-31.

[4] Internal Rev. Code § 851(b).

[5] As discussed below, it is this second argument that is eliminated in the proposed regulations.

[6] Guidance under Section 851 Relating to Investments in Stock and Securities, 81 Fed. Reg. 66,577 (Sept. 28, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-09-28/pdf/2016-23408.pdf.

[7] Simultaneous with the publication of Proposed Regulation 1.851-2, the IRS issued Revenue Procedure 2016-50, in which it states the IRS will no longer rule on whether a financial instrument or position is a security as defined in the 1940 Act.