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Internal Revenue Service Issues Guidance on the Treatment of Certain Commodity Derivatives held by Regulated Investment Companies -- Revenue Ruling 2006-1

On December 16, 2005, the Internal Revenue Service ("IRS") issued Revenue Ruling 2006-1 in which it ruled that income from derivative contracts based on commodity indices is not qualifying income for purposes of the 90 percent gross income requirement applicable to regulated investment companies ("RICs"). While the tax law has been clear that income from a direct investment in commodities does not produce "good income" under the 90 percent gross income requirement, it has not been clear until now whether RICs could recognize qualifying income based on the performance of the commodities market through the use of commodity-index derivatives.

The facts of the Ruling involve a RIC which invests substantially all of its assets in debt instruments and also enters into contracts with different counterparties under which it pays an amount equal to the 3-month U.S. Treasury bill rate plus a spread and either receives or pays an amount based on the total return gain or loss on a commodity index. The issue considered in the Ruling is whether income from a derivative contract that provides for a total return exposure on a commodity index is qualifying income for purposes of the 90 percent gross income requirement under section 851(b)(2) of the Internal Revenue Code of 1986, as amended ("Code"). Revenue Ruling 2006-1 concludes that the income from such a derivative contract is not qualifying income. The Ruling will apply prospectively to income recognized by a RIC after June 30, 2006.

The Tax Reform Act of 1986 expanded the types of income that would qualify under the 90 percent gross income requirement of section 851(b)(2) of the Code. As amended by the Tax Reform Act of 1986, section 851(b)(2) of the Code provides that a corporation will not be considered a RIC for any taxable year unless it derives at least 90 percent of its gross income from certain enumerated sources, specifically:

- A) 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 ("1940 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 and

- B) net income derived from an interest in a qualified publicly traded partnership (as defined in subsection (h) [of section 851]).

Section 851(b) also grants the Secretary authority to issue regulations which would exclude from qualifying income foreign currency gains which 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). Amendments to section 851(b)(2) made in 1986 added the 1940 Act reference and expanded the categories of qualifying income to include gains from the sale or other disposition of foreign currencies and other income derived with respect to a RIC's business of investing in stocks, securities or currencies.

Prior to issuance of Revenue Ruling 2006-1, there was no guidance on whether commodity-index based derivatives should be treated as securities, thereby giving rise to income which is qualifying income, for purposes of section 851(b)(2). Because of the cross-reference to the 1940 Act in section 851(b)(2), some practitioners have taken the position that since it was likely, although not entirely certain, that derivatives based on commodity indices would be securities under the 1940 Act, such derivatives should also be treated as securities for purposes of section 851. There are some RICs that offer exposure to the commodities market and invest substantially in these types of derivatives, and they have been operating for a number of years based on this position.

Revenue Ruling 2006-1 examines the legislative history of the 1986 amendments to section 851(b)(2) and concludes that Congress did not intend the amendments to provide for an expansive construction of the term "securities" but rather sought to include in the statute income that the IRS, in specific cases, had found to be qualifying income (i.e., derivative

contracts on stocks and securities, such as futures or options on stock indices). The IRS notes that the specific reference to foreign currency gains and the authority given to Treasury to exclude foreign currency gains not directly related to a RIC's principal business of investing in stocks or securities is further evidence of an intent to exclude from qualifying income any income from property other than stocks or securities and to construe the term "securities" narrowly for purposes of section 851(b)(2). Based on this analysis, the IRS concludes that an interpretation of the term "securities" that excludes derivative contracts which provide a total return exposure to a commodity index is consistent with the Congressional intent of the 1986 amendments to section 851(b)(2). The Ruling further concludes that since the RIC is using the derivatives to gain exposure to the price changes in certain commodities rather than to hedge a level of risk in (or for some other purpose connected to) a business of investing in stock, securities or currencies, the gains from the derivatives do not qualify as "other income" derived with respect to its business of investing in stock, securities or currencies.

Although Revenue Ruling 2006-1 specifically addresses derivatives based on a commodities index, it appears that the IRS would reach the same conclusion with respect to derivatives based on a specific commodity or commodity futures contract. The Ruling would, however, appear to permit a RIC to treat debt securities that have a return tied to a commodity index ("structured notes") as securities which would yield qualifying income under section 851(b)(2). Thus, by investing in structured notes rather than a total return swap or other commodity derivative contract, the RIC might be able to avoid the qualification issue posed by the Ruling. The structured notes would need to possess sufficient debt characteristics to be classified as indebtedness for federal income tax purposes, so as to avoid being classified as "derivatives" of the type considered in Revenue Ruling 2006-1, and those characteristics may materially alter the economic and tax consequences of the investment. Depending on the particular

features of the instrument, it is likely that close to 100 percent principal protection would be needed in order to achieve a high level of comfort that a structured note would be characterized as debt for federal income tax purposes. Business and regulatory constraints may affect a RIC's ability to use this alternative for accessing a commodity-based return.

RICs that wish to gain exposure to the commodities markets may also want to consider investing in publicly traded partnerships which are treated as "qualified publicly traded partnerships" under a new provision added to the Code by the

American Jobs Creation Act of 2004. Net income from a qualified publicly traded partnership is treated as qualifying income under section 851(b)(2), although asset diversification requirements applicable to RICs would limit investment in such entities to no more than 25 percent of a RIC's total assets. The new category of qualified income (from qualified publicly traded partnerships) would appear to mitigate the impact of Revenue Ruling 2006-1 and offer an opportunity for RICs, at least to the extent of 25 percent of their assets, to gain exposure to the commodities market.

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