



K&L GATES

2016 INVESTMENT MANAGEMENT CONFERENCE

Tax Developments

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INVESTMENT COMPANIES AND COMMODITIES

- Rev. Rul. 2006-1
 - “A derivative contract with respect to a commodity index is not a security for purposes of section 851(b)(2). Under the facts above, [the RIC’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 [the RIC’s] business of investing in stocks, securities or currencies.”
- Period from 2006 - 2011
 - IRS issues private letter rulings that OK RICs’ use of offshore subsidiaries and structured notes to gain exposure to commodity investments that otherwise produce non-qualifying income for RICs.
 - Under PLRs, offshore subsidiaries are not required to make distributions to allow controlled foreign corporation (CFC) inclusions to qualify as “good income” for RICs.
 - Under PLRs, structured notes are “securities.”
 - After commodities liberalization feature is stricken from the final version of the RIC Modernization Act in 2010, the IRS stops issuing these PLRs.



OFFSHORE SUBSIDIARIES FOR COMMODITY INVESTMENTS

PROPOSED REGULATIONS

- Income inclusions under “controlled foreign corporation” (CFC) rules are “good income” for RICs to the extent CFC earnings are distributed – section 851(b).
- IRS issued many PLRs that CFC distributions are not needed for inclusions to qualify as “good income”. Inclusions might, therefore, be considered good “other income.”
- CFTC questioned RICs’ use of CFCs to invest in commodities; unregistered commodity pools; CFTC objections increased IRS scrutiny of offshore commodity subsidiaries and commodity-linked notes.
- In 2011, IRS announced a moratorium on issuing further PLRs on commodity subsidiaries or commodity-linked notes.
- RICs’ investments in CFCs for purposes of indirectly investing in commodities have become more complicated as a result of newly 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.



REVENUE PROCEDURE 2016-50

- Contemporaneously with the publication of the Proposed Regulations, the IRS issued Revenue Procedure 2016-50, which provides that the IRS 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.”
- Issuance of PLRs addressing the status of commodity-linked structured notes is not expected to resume.
- Issuance of PLRs addressing the status of other financial instruments, which might be needed by RICs to determine eligibility of newly developed instruments, will not be easy to obtain.
- The preamble to the Proposed Regulations states that “[a]ny future guidance regarding whether particular financial instruments, including investments that provide RICs with commodity exposure, are securities ... is ... within the jurisdiction of the [Securities and Exchange Commission].” The IRS will generally no longer undertake the type of analysis demonstrated in Rev. Rul. 2006-1.



INSURANCE-DEDICATED FUNDS

- RICs that serve as investment vehicles for variable insurance accounts must satisfy a second set of diversification requirements under section 817(h).
- Investments of a segregated asset account are considered to be adequately diversified if (i) no more than 55% of the value of the total assets of the account is represented by any one investment; (ii) no more than 70% of the value of the total assets of the account is represented by any two investments; (iii) no more than 80% of the total assets of the account is represented by any three investments; and (iv) no more than 90% of the total assets of the account is represented by any four investments.
- For purposes of calculating diversification in the case of government securities, each government agency or instrumentality will be treated as a separate issuer and the term “government security” includes any security issued, guaranteed or insured by the United States or an instrumentality of the United States.



IRS Notice 2016-32

- On May 5, 2016, the IRS issued Notice 2016-32, which provides guidance regarding diversification requirements under section 817(h) for a segregated asset account that invests in a money market fund (MMF) that is a government MMF as defined in Rule 2a-7 of the 1940 Act.
- Rule 2a-7 requires that for a MMF to be defined as a government MMF, 99.5 percent or more of its total assets must be invested in cash, government securities, and/or repurchase agreements that are collateralized by cash items or government securities. Under the newly amended Rule 2a-7, nongovernment MMFs must be prepared to impose liquidity fees and may impose redemption gates. Government MMFs may impose these fees but are not required to.
- Under IRC Section 817(h)(6), each United States Government agency or instrumentality is treated as a separate issuer. Only a limited number of United States agencies or instrumentalities issue securities that a government MMF is allowed to hold under Rule 2a-7. Given conversion of MMFs to government MMFs, increased demand for certain government securities may exacerbate MMFs' difficulty in acquiring the assets needed to qualify as a government MMF and satisfy diversification requirements under IRC Section 817(h) and Reg. 1.817-5.



IRS NOTICE 2016-32 (CONTINUED)

- The Treasury Department and IRS determined that variable contracts should be able to offer government MMFs as an investment option. Notice 2016-32 explains that the Treasury Department and the IRS intend to amend Reg. Section 1.817-5 because of the anticipated increased demand for government securities and the expected difficulty in acquiring these assets.
- The Notice provides an alternative diversification requirement under Section 1.817-5 for a segregated asset account that invests in a government MMF. This alternative diversification requirement provides that a segregated asset account within the meaning of Section 1.817-5(e) is adequately diversified for purposes of section 817(h) if:
 1. No policyholder has investor control: and
 2. Either:
 - (a) The account is a government MMF under Rule 2a-7(a)(14): or
 - (b) The account invests all of its assets in an “investment company, partnership, or trust” as defined in Reg. 1.817-5(f)(1) that satisfies the look-through rules in Reg. 1.817-5(f) and qualifies as a government MMF under Rule 2a-7(a)(14).



MORE ON INSURANCE-DEDICATED FUNDS

- Fannie Mae and Freddie Mac each issue and guarantee mortgage-backed securities backed by pools of single-family mortgage loans. The securities issued by Fannie Mae are known as Mortgage-Backed Securities (MBS), and the securities issued by Freddie Mac are known as Participation Certificates (PCs).
- Most trading of Fannie Mae MBS and Freddie Mac PCs backed by fixed-rate mortgage loans occurs in the TBA market, which is a type of forward market in mortgage-backed securities. The actual security to be delivered to fulfill a TBA trade is not designated at the time the trade is made. Rather, on the trade date, six criteria are agreed on: the issuer (either a Freddie Mac PC or a Fannie Mae MBS), the maturity, the coupon rate, the face value, the price, and the settlement date (one, two or three months forward). The specific securities delivered to complete the trade are “to be announced” 48 hours prior to the settlement date (the “48 hour day”).



FANNIE MAE AND FREDDIE MAC UMBS

- The agencies have proposed to change the TBA market to allow a trade to be settled in Uniform Mortgage-Backed Securities (UMBS) that consist of either Fannie Mae UMBS or Freddie Mac UMBS. Specifically, in this new TBA market the issuer will no longer be designated on the trade date of the transaction. Thus, the purchaser will only be informed of the issuer of the UMBS security that will be delivered two days before settlement of the trade (i.e., on the 48 hour day).
- This will potentially create issues complying with the diversification requirements under various areas of the Internal Revenue Code, including section 817(h) which provides diversification requirements for variable annuity, endowment and life insurance contracts based on segregated asset accounts.
- The agencies have requested comments with respect to this proposed change in the TBA market.

