

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact: _____, ID No. _____

Telephone Number: _____

Refer Reply To:
CC:FIP:B01
PLR-129493-10
Date:
October 28, 2010

Legend:

Fund =

Trust =

Advisor =

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Dear _____ :

This responds to your request for a ruling dated July 13, 2010, and supplemental correspondence dated October 8, 2010, submitted on behalf of Fund. Fund requests a ruling that income from CPI swaps will be qualifying income under section 851(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code").

Facts:

Trust is a State business trust registered as an open-end investment company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the "1940 Act"). Fund is a non-diversified series of Trust. Fund represents that it has elected (or will elect upon filing of its first tax return) to be taxable as a regulated investment company ("RIC") under subchapter M of the Code. Fund is advised by Advisor.

Fund invests in municipal securities. Fund intends to provide full inflation hedging coverage for its municipal bond portfolio by entering into CPI-U NSA based swap contracts (“CPI Swaps”) with investment grade counterparties. Advisor intends to cause Fund to enter into CPI Swaps when it purchases municipal bonds in notional principal amounts approximating the market value of such municipal bonds. The hedging process to be entered into by the Fund will be “passive,” and the Fund likely will only vary the amount of the CPI Swaps in a corresponding manner to any changes made in the underlying portfolio of municipal bonds.

The CPI Swap references the Consumer Price Index Urban Non-Seasonally Adjusted (“CPI-U NSA”), which is a non-seasonally adjusted measure for estimating inflation by referencing changes in the price levels for urban consumers of a standard basket of goods and services. Because inflation equates to a diminished value of a currency, Fund will enter into the CPI Swap in order to manage the effect of inflation upon the value of the portfolio by receiving inflation indexed payments. The CPI swap is a fixed maturity, over-the-counter derivative in which the counterparty receives the “realized” rate of inflation as measured by the CPI over the life of the swap. The zero-coupon CPI swap is a “bullet” structure, where all cash flows are exchanged at maturity.

Law and Analysis:

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.

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 stocks or securities.” Section 851 did not contain its own definition of the term “securities,” but section 851(c)(5) provided that, for the purposes of the asset test, “all other terms shall have the same meaning as when used” in the 1940 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 1940 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 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 . . .

Section 2(a)(36) of the 1940 Act defines the term "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.

The CPI Swaps entered into by Fund are not stock, debt instruments, or currency (or options, futures, or forward contracts with respect to stock, debt instruments, or currency). A swap is not specifically enumerated as a security in section 2(a)(36) of the 1940 Act, and there is no conclusive authority that interprets this definitional provision to include a swap. Rev. Rul. 2006-1, 2006-1 C.B. 261, 262, as clarified by Rev. Rul. 2006-31, 2006-1 C.B. 1133. Nevertheless, under section 851(b)(2), Fund's income from the CPI Swaps may be "other income (including but not limited to gains from options, futures or forward contracts) derived with respect to [Fund's] business of investing in such stock, securities, or currencies" (hereinafter, "other income") if the CPI Swaps are securities for purposes of section 851(b)(2). Id.

The Securities and Exchange Commission ("SEC") generally interprets the securities laws under the 1940 Act broadly so as to effectuate Congress' purpose of protecting investors by bringing many types of financial instruments under the SEC's review and regulation. In contrast, in determining whether a financial instrument is a security for purposes of section 851(b)(2), the Service applies principles of tax law, including those of subchapter M of the Code and accompanying legislative history, to analyze a financial instrument that is not specifically enumerated as a security under the 1940 Act.

In the case of a derivative instrument, this analysis takes into account several factors, including, but not limited to, the following: (1) the nature of the derivative's underlying referent; (2) the tax principles and the Congressional intent underlying the enactment and amendment of subchapter M of the Code, including the effects of the

1986 amendments to section 851(b)(2), which added the “other income” provision and the cross-reference to the definition of securities in the 1940 Act; and (3) the extent to which a RIC generates income and gain from the derivative that is passive in nature and akin to the passive income that the RIC generates from securities enumerated as such under the 1940 Act.

Underlying Referent

Rev. Rul. 2006-1 addresses a derivative instrument whose value is based on the performance of a commodities index. Neither the derivative under discussion in that ruling nor its underlying commodities index is a specifically enumerated security within the definition of a “security” under the 1940 Act. The revenue ruling explains, however, that it is nevertheless appropriate to examine whether the commodities derivative is a security for purposes of section 851(b)(2) by considering the effect of the 1986 Amendment to that section and its accompanying legislative history. The revenue ruling concludes that:

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).

In this case, as in Rev. Rul. 2006-1, neither the CPI Swaps nor their underlying referents are specifically enumerated in the 1940 Act definition of a security. Congress has consistently excluded commodities from the definition of a security, and, as a result, Rev. Rul. 2006-1 appropriately concludes that a derivative contract on a commodities index does not produce qualifying income. The underlying referent for the CPI Swap at issue in this ruling is the CPI-U NSA. Although the CPI-U NSA includes the value of certain baskets of commodities in measuring the average change in prices over time of goods and services of urban consumers, the annual percentage change of the CPI-U NSA is predominantly used as a measure of inflation. Thus, unlike the derivative discussed in Rev. Rul. 2006-1, an investment in a derivative referencing the CPI-U NSA is not predominantly an indirect investment in commodities.

Congressional Intent

In concluding that the commodities derivative in question was not a security for purposes of section 851(b)(2), Rev. Rul. 2006-1 explains that Congress did not intend the cross-reference to the 1940 Act to incorporate into section 851(b)(2) an expansive construction of the term “securities.” *Id.* at 264. Congress’ 1986 addition of the other income clause to section 851(b)(2) served a specific purpose, which was to expand the

statutory description of qualifying income to include the types of income that the Service, in specific cases, had already treated administratively as qualifying income.

Income upon which the Service had specifically ruled favorably before the 1986 amendments included income from certain 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 derivative’s underlying referent may be a collection of stocks or securities, rather than a specific stock or security. Also within this category was the receipt of “recovery” income, such as recovery of excess management fees, recovery of damages, and recovery of state taxes. 132 Cong. Rec. 4045, 4047-8 (1986) (remarks of Senator Armstrong, inserting letter of J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy), dated February 5, 1986, to Rep. Flippo). In the recovery cases, the RIC receives reimbursements of income directly or indirectly generated from investments in stock, securities, or currencies. Id.

Prior to the enactment of the “other income” clause, the Service held that exchange traded futures contracts on United States Government securities, futures contracts on financial instruments, futures on domestic and Eurodollar certificates of deposit (“CDs”), and other interest rate contracts are section 851(b)(2) securities. Their pricing and economics make the CPI Swaps at issue akin to the instruments that the Service has previously determined to be section 851(b)(2) securities.

Passive Nature of Income

Congress has explained that the favorable RIC tax provisions are intended for passive investment entities not engaged in active business and that a RIC’s investments should be limited to income from stocks and securities, as opposed to other property. Mr. Mentz’s letter, cited above, explained the fundamental policy served by the qualifying income requirement:

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 the 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 trading of portfolio securities is treated for federal income tax purposes as less active than other comparable business activities and produces qualifying income.

Fund generates income and gain from investments in CPI Swaps that are equally passive in nature to that generated from investments in other section 851(b)(2) securities. Like an investment in Treasury Inflation Protected Securities ("TIPS") (the principal of which increases with inflation and decreases with deflation, as measured by the CPI-U NSA), Fund utilizes a CPI Swap to capture inflation accrual and not as a surrogate for investment in active trading in commodities or other goods and services. In the case at hand, Fund is, in essence, replicating the benefits of the inflation protection of TIPS with the base securities being municipal bonds instead of U.S. Treasury securities. The two investments will generate income whose character is equally passive in nature, despite the fact that the CPI Swap structure adds counterparty risk and additional costs that a portfolio of TIPS avoids.

Conclusion:

We rule that the CPI Swaps described in this letter are securities for purposes of section 851(b)(2) and, accordingly, that income generated by Fund's investment in the CPI Swaps is "other income" that is qualifying income under section 851(b)(2).

Except as specifically ruled upon above, we express no opinion on the federal tax consequences of the transactions described above under any other provisions of the Code and regulations. In particular, no opinion is expressed concerning whether the Fund otherwise qualifies as a RIC under subchapter M, part I of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Rich LaFalce
Rich LaFalce
Assistant to the Branch Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions and Products)