

IRS Letter Rulings and TAMs (1954-1997), UIL No. 851.02-00 Definition of regulated investment company, Gross income requirement; UIL No. 7704.00-00, Letter Ruling 9105014, (Oct. 31, 1990), Internal Revenue Service, (Oct. 31, 1990)

Letter Ruling 9105014, October 31, 1990

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Definition of regulated investment company

- Gross income requirement

UIL No. 7704.00-00

[Code Secs. 851 and 7704]

This is in reply to your letter of February 23, 1990, and subsequent correspondence, written on behalf of Partnership, concerning whether income from certain investments that the Partnership expects to make will constitute "qualifying income" within the meaning of Section 7704(d) of the Internal Revenue Code.

FACTS

The information submitted discloses that Partnership was organized on x as a limited partnership under the laws of state Y. Partnership filed a registration statement with the Securities and Exchange Commission (SEC) on November 17, 1987, under the Investment Company Act of 1940 and the Securities Act of 1933. The registration statement stated that Partnership will be an open-end investment company which will stand ready, in accordance with SEC rules, to redeem for cash at net asset value the units in Partnership tendered for redemption, thereby indicating that Partnership was to be a publicly traded partnership.

Under the registration statement the principal investment objective of Partnership was to seek short-term capital appreciation, primarily through the purchase and sale of put and call options on stocks, stock indices, and foreign currencies traded on national securities exchanges and on certain foreign exchanges. In addition, Partnership would have been able to invest in equity securities for limited periods of time in connection with its options trading, as well as in short-term government securities, money market instruments, and repurchase agreements.

Partnership has amended its registration statement to permit Partnership to invest in a broader range of financial instruments (Newly Permitted Investments) provided that such instruments give rise only to income that constitutes "qualifying income" within the meaning of section 7704(d) of the Code.

Newly Permitted Investments would include transactions (on U.S. and foreign exchanges) in futures contracts on stock indices, bond indices, debt instruments (including, but not limited to, U.S. Treasury securities, other U.S. Government securities (such as Government National Mortgage Association certificates), foreign government securities, commercial paper, and domestic and foreign certificates of deposit), and other financial futures the values of which are determined in whole or in part by reference to the values of one or

more securities or groups of securities. Newly Permitted Investments also would include transactions (on U.S. and foreign exchanges) in options on such financial futures.

On October 6, 1989, this office issued a ruling letter to Partnership which held that Partnership qualified as an "existing partnership" within the meaning of section 10211(c)(2)(A) of the Revenue Act of 1987 and would continue to qualify as an "existing partnership" within the meaning of section 10211(c) of the Revenue Act of 1987 after the filing of its amended registration statement provided that the new line of business generated only "qualifying income" within the meaning of section 7704(d) of the Code.

LAW AND ANALYSIS

The Revenue Act of 1987, Pub L. No. 100-203, added section 7704 of the Internal Revenue Code. Section 7704 of the Code provides that a publicly traded partnership shall be treated as a corporation.

Section 7704(b) of the Code provides that the term "publicly traded partnership" means any partnership if (1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 10211(c)(1) of the Revenue Act of 1987 provides that section 7704 of the Code shall apply (A) to taxable years beginning after December 31, 1987, or (B) in the case of an "existing partnership" to taxable years beginning after December 31, 1997. Section 10211(c)(2) of the Act provides that the term "existing partnership" includes any partnership if a registration statement indicating that such partnership was to be a publicly traded partnership was filed with the SEC with respect to such partnership on or before December 17, 1987.

Section 10211(c)(2)(B) of the Act provides a special rule in the event that an "existing partnership" adds a new line of business. That section provides that a partnership that would be treated as an existing partnership will cease to be treated as an existing partnership as of the first day after December 17, 1987, on which there has been an addition of a substantial new line of business with respect to such partnership.

Notice 88-75, 1988-2 C.B. 386, provides that in determining whether a publicly traded partnership is to be treated as having added a "substantial new line of business," a "new activity of a partnership will not be considered to be a new line of business within the meaning of section 10211(c)(2)(B) of the Act to the extent that an activity generates qualifying income as defined in section 7704(d) of the Code."

Section 7704(d)(4) provides that the term "qualifying income" includes any income which would qualify under section 851(b)(2) or 856(c)(2).

Section 851(b)(2) of the Code provides that to qualify as a regulated investment company a company must derive at least 90 percent of its gross income for the taxable year from 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, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to the company's business of investing in such stock, securities, or currencies. (emphasis added)

Section 2(a)(36) of the Investment Company Act defines the term "security" to mean any note, stock, treasury stock, 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.

A registration statement was filed with the SEC before December 17, 1987, and the registration statement states that the limited partner's shares may be redeemed upon request. Partnership was, therefore, a "publicly traded partnership" on December 17, 1987. The Partnership's expansion of its investment activities to include the purchase and sale of the above-described Newly Permitted Investments will not cause the partnership to cease being an existing partnership if those Newly Permitted Investments generate qualifying income.

We conclude that income derived by Partnership from transactions (on U.S. and foreign exchanges) in futures contracts on stock indices, bond indices, debt instruments (including, but not limited to, U.S. Treasury securities, other U.S. Government securities, such as Government National Mortgage Association certificates, foreign government securities, commercial paper, and domestic and foreign certificates of deposit), and other financial futures the values of which are determined in whole or in part by reference to the values of one or more securities or groups of securities, as well as transactions (on U.S. and foreign exchanges) in options on such financial futures will qualify under section 851(b)(2) because it is "other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to the company's business of investing in such stock, securities, or currencies."

CONCLUSION

The gross income derived by Partnership from the above described Newly Permitted Investments will be qualifying income under section 7704(d)(4) of the Code. Therefore, Partnership will not be regarded as having entered into a "substantial new line of business" within the meaning of section 10211(c)(2)(B) of the Act solely because it invests in those Newly Permitted Investments.

Except as specifically ruled upon above no opinion is expressed concerning the federal income tax consequences of the above described facts under any other provision of the Code. In particular, no opinion is expressed concerning whether Partnership is, in fact, a partnership for federal tax purposes.

A copy of this ruling should be attached to the next return filed for Partnership.

In accordance with the power of attorney on file, we are forwarding a copy of this letter to Partnership.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in the ruling. See section 8.05 of Rev. Proc. 90-1, 1990-1 C.B. 356. However, when the criteria in section 8.06 of Rev. Proc. 90-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.