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Department of the Treasury

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Date:

March 12, 2015

Legend:

Fund 1 =

Fund 2 =

Fund 3 =

State =

Dear

This responds to the request dated September 22, 2014, for a ruling that income of Fund 1, Fund 2, and Fund 3 (collectively, "Funds") from CPI Swaps (defined below) is other income derived with respect to Funds' respective businesses of investing in stock and securities within the meaning of Section 851(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code").

Facts:

Each Fund is a State business trust registered as an open-end management investment company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq. as amended (the "1940 Act"). Funds 1 and 2 invest in municipal bonds, and Fund 3 invests in preferred securities. Each Fund has an investment objective that includes an inflation hedge overlay, the purpose of which is to preserve the purchasing power of

invested principal. To achieve that objective Funds intend to enter into swaps the payouts of which reference the Consumer Price Index - All Urban Consumers ("CPI-U"), non-seasonally adjusted ("CPI Swaps"). The CPI-U is a measure of the average change over time in the price paid by urban consumers for a standard basket of goods and services, and is published by the U.S. Bureau of Labor Statistics on a monthly basis. The CPI Swaps will be fixed maturity instruments in which the Funds receive or make a single payment representing the difference between the "realized" rate of inflation, as measured by the index over the life of the swap, and the rate that fairly represents inflation expectations on the date the swap is entered into, multiplied by the notional amount.

Each Fund has elected and qualified as a regulated investment company ("RIC") under subchapter M of the Code.

Each Fund has provided the representations set forth below. For purposes of these representations, a "Hedged Security" means a security the return of which has no component of inflation protection. The term "Hedged Security" therefore excludes, for example, a Treasury Inflation Protected security and certain variable rate instruments.

1. The notional amount of the Fund's CPI Swaps will not exceed an amount reasonably calculated to reduce the Fund's level of inflation risk with respect to its investment in the Fund's Hedged Securities;
2. The total notional amount of the Fund's CPI Swaps will not exceed an amount reasonably calculated to equal the total fair market value of the Fund's Hedged Securities;
3. The bonds and preferred securities that the CPI Swaps are intended to hedge qualify as "securities" under section 851(b)(2);
4. The Fund will implement its inflation hedge strategy at the portfolio level by seeking to enter into the CPI Swaps substantially contemporaneously with the acquisition of the securities in its portfolio. The books and records of the Fund will provide the date of each acquisition of a security and the substantially contemporaneous date on which the Fund entered into the related CPI Swap. The Fund will continue to monitor the hedge strategy to make adjustments to the CPI Swaps to take into account changes with respect to the portfolio of Hedged Securities consistent with these representations; and
5. The Fund enters into CPI Swaps primarily to manage or reduce the effects of inflation on Hedged Securities.

Law:

Section 851(a) of the Code defines a RIC, in part, as a domestic corporation registered under the 1940 Act as a management company.

Section 851(b) limits the definition of a RIC to a corporation meeting certain election, gross income, and diversification requirements.

Section 851(b)(2) 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 (such income is referred to as “qualifying income”).

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 purpose of section 851(b)(3) (the “asset diversification test”), “[a]ll other terms shall have the same meaning as when used” in the 1940 Act.”¹

The 1986 Act expanded the meaning of qualifying income under section 851(b)(2) by adding: (1) an explicit cross-reference to the definition of “securities” in the 1940 Act; (2) gains from the sale or other disposition of foreign currencies; and (3) an “other income” provision. As so amended, qualifying income under section 851(b)(2) includes, in relevant part –

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) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its 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,

¹ Section 851(c)(5) of the Code was redesignated as section 851(c)(6) by the American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 331(c) (10-22-2004).

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.

Analysis:

In analyzing whether a derivative financial instrument generates qualifying income under the “other income” clause of section 851(b)(2), we examine the relationship between the item of income and the RIC’s business of investing in stock, securities, or currencies.

Funds represent that the bonds and preferred securities they hold are “securities” under section 851(b)(2) and that their positions in CPI Swaps are reasonably calculated to reduce their inflation risk with respect to Hedged Securities. Based on the representations provided, the payments that Funds expect to receive from CPI Swaps and the expected corresponding decrease in the inflation-adjusted value of Fund’s direct investment in Hedged Securities demonstrate the requisite relationship between the income generated by each Fund’s positions in CPI Swaps and the Fund’s business of investing in stock and securities.

In amending section 851(b)(2) in 1986, Congress inserted parenthetical language that specifically listed income “including but not limited to gains from options, futures or forward contracts” as types of income that may be other income derived with respect to a RIC’s business of investing in stock, securities, or currencies (emphasis added).

Congress has explained that the favorable RIC tax provisions are intended for passive investment entities that do not engage in active business. Staff of J. Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, at 377 (JCS-10-87). The legislative history suggests that a RIC’s investments should be limited to income from stocks and securities, as opposed to other property:

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.

132 Cong. Rec. 4048 (1986) (remarks from Senator Armstrong, inserting letter of J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy), dated February 5, 1986, to Rep. Flippo).

The CPI-U, the referent for the CPI Swaps, is a commonly used measure of inflation, and, based on the facts and representations set forth above, the CPI Swaps

will be used to reduce inflation risk with respect to Hedged Securities, investments that are securities for purposes of section 851(b)(2).

Conclusion:

We rule for each Fund that income and gain from the CPI Swaps described herein is other income derived with respect to its business of investing in stock and securities within the meaning of section 851(b)(2) of the Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed whether each Fund otherwise qualifies as a RIC under part I of subchapter M of chapter 1 of the Code, whether Funds' investments are securities under section 851(b)(2), or whether gains generated by Funds' CPI Swaps may also be qualifying income from the sale or other disposition of stock or securities under section 851(b)(2).

This ruling is directly only to the taxpayers requesting it. Section 6110(k)(3) of the Code 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,

Steven Harrison
Branch Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions and Products)