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New York State Bar Association

Tax Section

Report on Proposed Regulations under Section 851 Dealing with Imputations from CFCs and PFICs

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Dealing with Imputations from CFCs and PFICs

This report[1] responds to a request for comments on Proposed Regulation § 1.851-2(b).[2] The proposed regulation would interpret how section 851(b)(2)(A)[3] (the "**Good Income Test**") applies to income recognized under sections 951(a)(1)(A)(i) or 1293(a) ("**Subpart F/QEF Imputations**") or sections 951(a)(1)(A)(ii), 951(a)(1)(A)(iii) or 951(a)(1)(B) ("**Other CFC Imputations**" together with Subpart F/QEF Imputations, "**CFC/PFIC Imputations**").

Under the Good Income Test, a "regulated investment company" within the meaning of section 851(a) (a "**RIC**") will not be treated as a RIC unless at least 90 percent of its gross income comes from specified sources ("**Good Income**" and all other, "**Bad Income**"). As relevant to the proposed regulation, Good Income includes "dividends…or other income...derived with respect to [a RIC's] business of investing in such stock, securities, or currencies." Section 851(b) further provides that for purposes of the Good Income Test:

> there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A)(i) or 1293(a) for the table year to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of earnings and profits of the taxable year which are attributable to the amounts so included. (the "**Imputation/Distribution Rule**")

Proposed Regulation § 1.851-2(b) would add two new rules. The first would provide that, for purposes of the Good Income Test, Subpart F/QEF Imputations "are treated as dividends *only* to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution

1 This report was prepared by a working group consisting of Kimberly S. Blanchard, Robert Cassanos, Christopher Chang, Kenneth Curran, Lucy W. Farr, Marcy G. Geller, Stephen B. Land, Stephen E. Shay, Willard B. Taylor, and Edward Torres, with James R. Brown as the principal drafter. Helpful comments were made by Michael S. Farber, Michael L. Schler, W. Kirk Wallace and Diana L. Wollman. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

2 Notice of Proposed Rulemaking, *Guidance under Section 851 Relating to Investments in Stock and Securities,* REG-123600-16, 81 Fed. Reg. 66576 (Sept. 28, 2016) (the "**Notice**").

3 Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "**Code**").

out of earnings and profits of the taxable year which are attributable to the amounts so included." [emphasis added] (the "**Dividend Proposal**"). The second would provide that, for purposes of the Good Income Test, CFC/PFIC Imputations "are not treated as other income derived with respect to a corporation's business of investing in such stock, securities, or currencies." (the "**Main Proposal**").

The Notice also requests comments on whether the Internal Revenue Service (the "**Service**") should withdraw Revenue Ruling 2006-1, Revenue Ruling 2006-31 and related guidance (the "**Prior Guidance**"). The Prior Guidance addresses whether certain commodity-linked instruments will be treated as "securities" within the meaning of the Investment Company Act of 1940, as amended (the "**1940 Act**") for purposes of applying the Good Income Test and a diversification test contained in section 851(b)(3) (the "**Securities Issue**") and whether income from these commodity-linked instruments will be treated as derived with respect to the taxpayer's business of investing in stocks, securities or currencies if the taxpayer's only other assets consists of debt instruments the value of which approximately equals the notional value of the commodity-linked instruments (the "**Other Income Issue**").

I. RECOMMENDATION

We recommend that final regulations adopt the Dividend Proposal but not the Main Proposal. We further recommend that, in lieu of the Main Proposal, final regulations provide that CFC/PFIC Imputations derived with respect to a business of investing in stocks, securities or currencies be treated as Good Income regardless of whether the imputed income is distributed.

We are not providing comments on the question of whether the Prior Guidance should be withdrawn. As to the Securities Issue, we are not competent to comment on whether any particular commodity-linked instrument is a security within the meaning of the 1940 Act, and we are unaware of any tax policy that would be advanced by the Service making that determination in the form of published guidance in the absence of guidance from the Securities and Exchange Commission.[4] As to the Other Income Issue, we agree with the conclusion of Revenue Ruling 2006-1 insofar as it indicates that, under the facts presented in the ruling, the income from the commodity-linked instruments is not derived with respect to the business of investing in debt securities. We also believe, however, that preserving the ruling's holding on the Other Income Issue and not preserving the ruling's holding on the Security Issue would be potentially confusing and misleading.

[4] The Notice states "…the 1940 Act…grants exclusive rulemaking authority under the 1940 Act to the Securities and Exchange Commission (SEC), including 'defining accounting, technical, and trade terms' under in the 1940 Act."

II. Background

Section 951(a)(1)(A)(i) imputes "subpart F income" as defined in section 952 of a controlled foreign corporation as defined in section 957 (a "**CFC**") to the CFC's U.S. shareholders as defined in section 951(b) (each, a "**U.S. Shareholder**"). Before 1975, section 963 generally provided that a U.S. Shareholder would not be imputed subpart F income from a CFC if the CFC distributed a specified minimum amount of its earnings and profits for the taxable year ("**Current E&P**").

Section 951(a)(1)(A)(ii) and (iii) imputes to a CFC's U.S. Shareholders specified amounts of the CFC's "previously excluded subpart F income" (as determined under section 955(a)(3) and a predecessor provision). Section 951(a)(1)(B) imputes to a CFC's U.S. Shareholders the amount determined under section 956 with respect to such shareholders ("**Section 956 Inclusions**"). Section 963 did not limit these imputations.

In 1975, Congress repealed section 963[5] and introduced the predecessor of the Imputation/Distribution Rule, which generally treated distributed subpart F income as Good Income.[6] The legislative history to the 1975 Act does not discuss the rationale for this rule, or why the rule did not apply to Other CFC Imputations. However, a committee report for a prior bill proposing this rule explained that it "corrects a problem in existing law" whereby a RIC's recognition of subpart F income could result in the RIC's disqualification "even if the investment company receives for the taxable year an actual distribution from the controlled foreign corporation."[7] This explanation continued by noting:

> Under present law regulated investment companies meet this problem by receiving a minimum distribution…. However [with the repeal of section 963], this method of avoiding possible disqualification … will not be available…. Consequently, your committee's bill provides that amounts received as deemed distributions are treated as dividends to a regulated investment company to the extent that there is an actual distribution … out of earnings and profits of the taxable year which are attributable to the deemed distribution.[8]

[5] Tax Reduction Act of 1975, Pub. L. 94-12 § 602(a)(1), 89 Stat. 26, 58 (the "**1975 Act**").

[6] P.L. 94-12 § 602(a)(2), 89 Stat. 26, 58. This predecessor version was identical to the current Imputation/Distribution Rule except for the treatment of imputation under Section 1293, which, as explained below, was not enacted until 1986, when the Imputation/Distribution Rule was expanded to cover imputations under that section as well.

[7] H.R. Rep. No. 93-1502, at 131 (1974).

[8] *Id.*

In 1986, Congress enacted new rules for the taxation of income and gains from investments in a passive foreign investment company ("**PFIC**") held directly or indirectly by U.S. persons.[9] Like the CFC rules, the PFIC rules are intended to prevent tax deferral by U.S. persons.[10] Under these rules, a U.S. shareholder of a PFIC may elect to treat the PFIC as a qualified electing fund (a "**QEF**") and thereby recognize its share of the PFIC's ordinary earnings and net capital gain ("**QEF Inclusions**"). Alternatively, under these rules, a U.S. shareholder of marketable PFIC stock may elect to mark to market that stock,[11] and RICs are generally permitted to treat all PFIC stock as marketable for this purpose.[12]

The 1986 Act also adopted the current version of the Imputation/Distribution Rule and thereby expanded the Good Income Test to treat distributed QEF Inclusions like distributed subpart F income.[13] It also treated as dividends for purposes of the Good Income Test amounts included in income from PFIC stock under a mark-to-market election (the "**MTM PFIC Rule**").[14] Finally, the 1986 Act expanded the definition of Good Income to include:

> other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to [a RIC's] business of investing in such stock, securities or currencies.[15] (the "**Other Income Provision**")

The legislative history to the 1986 Act does not address whether Congress intended Subpart F/QEF Imputations, Other CFC Imputations or mark-to-market income from PFICs to be covered by or excluded from the Other Income Provision. This history indicates, however, that the Other Income Provision was supported by the Department of Treasury ("**Treasury**"),[16] and testimony from a Treasury official indicates that this provision was intended to allow for the "liberalization of the types of income RICs may receive to include the passive investment in-

[9] Tax Reform Act of 1986, Pub. L. No. 99-514 (the "**1986 Act**").

[10] H.R. Rep. No. 99-841 (1986) (Conf. Rep.), at II-641 ("The conferees believe that eliminating the economic benefit of deferral is necessary to eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds.")

[11] I.R.C. § 1296(a).

[12] I.R.C. § 1296(e)(2).

[13] Tax Reform Act of 1986, Pub. L. No. 99-514 § 1235(f)(3), 100 Stat. 2085, 2575.

[14] I.R.C. § 1296(h).

[15] Tax Reform Act of 1986, Pub. L. No. 99-514 § 653(a), 100 Stat. 2085, 2298.

[16] 132 Cong. Rec. S8204 at 14992 (daily ed. June 24, 1986) (statement of Sen. Armstrong) ("The desire of the industry, which is supported, I think, without controversy or objection and enjoys the support of the Treasury Department, is to permit the mutual fund industry to make better use of income from stock options, futures contracts and options on stock industries, options and futures of foreign currencies, and foreign currency transactions.").

come sources specified [in the provision]" subject to the imperative that "RICs should not be permitted to engage in an active business." [17] So that RICs are properly restricted, according to this testimony, Good Income should be subject to two limitations:

> First, permitted income 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, such income should be limited to income from stocks and securities as opposed to other property.[18]

In this testimony, Treasury expressed opposition to "any expansion of these rules to include gains from sales of other types of assets, such as commodities."[19]

In 1987, Congress enacted section 7704[20] to treat as a corporation a "publicly traded partnership" (a "**PTP**") as defined in section 7704(b), unless both 90 percent of the PTP's gross income comes from specified sources ("**PTP Good Income**") and it would not be described in section 851(a) if the PTP were a domestic corporation.[21] PTP Good Income generally includes, among other types, both (i) income from commodities, if a principal activity of the PTP is buying and selling commodities (other than inventory) or options, futures or forwards with respect to commodities, and (ii) Good Income under section 851(b)(2)(A).[22]

In 2004, Congress again expanded the Good Income Test to include net income from a "qualified publicly traded partnership" (a "**QPTP**"),[23] which is generally any PTP other than one that would have satisfied the Good Income Test without this expansion.[24] The Good Income treatment of income from other partnerships is determined at the partnership level.[25] Under a di-

[17] *See* Statement of Dennis E. Ross, Tax Legislative Counsel, U.S. Treasury Department, in "Hearings on Issues Relating to Passthrough Entities" before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means at 137 (June 10, 1986).

[18] *Id.*

[19] *Id.*

[20] Revenue Act of 1987, Pub. L. No. 100-203 § 10211(a), 100 Stat. 1330, 1330-403 to 1330-405.

[21] This means that a PTP registered as an investment company under the 1940 Act cannot rely on this income test to avoid being treated as a corporation. The statute permits regulatory exceptions to that rule for PTPs that principally trade in commodities, but no regulatory exception has been issued. I.R.C. § 7704(c).

[22] I.R.C. § 7704(d).

[23] American Jobs Creation Act of 2004, Pub. L. 108-357 § 331(a), 118 Stat. 1418, 1476.

[24] I.R.C. § 851(h).

[25] I.R.C. § 851(b).

versification requirement, a RIC must limit its interests in securities of QPTPs to not more than 25 percent of the value of the RIC's total assets.[26]

After some RICs began to invest in commodity-linked swaps, the Service issued Revenue Ruling 2006-1, which held that those instruments are not securities for purposes of the Good Income Test, and that income and gain from those swaps is not Good Income under the Other Income Provision. Revenue Ruling 2006-31 narrows the holding of Revenue Ruling 2006-1 to the instruments described in that ruling, and states that it was not intended to preclude other commodity-linked instruments from being treated as securities for purposes of the Good Income Test.

Later in 2006, the Service began issuing private letter rulings ("**PLRs**") addressing the Good Income treatment of income and gain from commodity-linked notes or from CFCs that trade in commodities. As to CFC investments, some of the rulings hold that a RIC's "subpart F income" is Good Income under the Other Income Provision regardless whether the income was distributed,[27] and other rulings hold that "income from investments" in CFCs is Good Income "whether or not attributable to subpart F income."[28] These latter rulings do not include any statements about the CFCs intentions to distribute their subpart F income. None of the rulings separately address Section 956 Inclusions or provide an analysis for their conclusion. The Service issued over 50 rulings addressing income from commodities-trading CFCs over approximately six years.

Contemporaneously, the Service issued two PLRs concluding that a PTP's Subpart F/QEF Imputations qualify as Good Income under section 851(b)(2) and therefore as PTP Good Income regardless of whether distributed.[29] The PLRs indicate the CFCs and PFICs held by the PTPs receiving the rulings would primarily invest in debt obligations and earn interest. In reaching their conclusion, they identify the Imputation/Distribution Rule and Other Income Provision as being separate bases for Good Income treatment, and then state that "all of [the taxpayer's] income from its subsidiaries [that are CFCs or PFICs] will be derived as a result of its stock ownership and will be 'income derived with respect to its business of investing in such stock' under the other income rule."

In addition, the Service issued a number of PLRs to real estate investment trusts ("**REITs**") concluding that Subpart F/QEF Imputations would qualify toward the satisfaction of

[26] I.R.C. § 851(b)(3)(B).

[27] *See, e.g.,* I.R.S. Priv. Ltr. Rul. 201122012 (June 3, 2011); I.R.S. Priv. Ltr. Rul. 201102047 (Jan. 14, 2011); I.R.S. Priv. Ltr. Rul. 201042001 (Oct. 22, 2010); I.R.S. Priv. Ltr. Rul. 200946036 (Nov. 13, 2009).

[28] *See, e.g.,* I.R.S. Priv. Ltr. Rul. 201206015 (Feb. 10, 2012).

[29] *See* I.R.S. Priv. Ltr. Rul. 200722007 (June 1, 2007); I.R.S. Priv. Ltr. Rul. 200728025 (July 13, 2007).

the REIT income test contained in Section 856(c)(5) without regard to whether the imputed amounts are distributed.[30] The rulings were issued under the authority granted in section 856(c)(5)(J), which allows the Service to determine the qualification treatment of an item of income or gain not otherwise qualifying under section 856(c)(2) or (3). For support, the rulings point to legislative history stating that a principal purpose of this income test is to "be sure the bulk of [a REIT's] income is from passive sources and not from the active conduct of a trade or business."[31]

In 2010, Congress passed the RIC Modernization Act.[32] Before voting unanimously in favor of that legislation, the Senate removed a provision from the version passed unanimously by the House of Representatives that would have treated income from commodities trading as Good Income (the "**Commodity Proposal**").[33] No legislation was proposed during this period that would have modified the holdings of the PLRs that address the qualifying income treatment Subpart F/QEF Imputations recognized by RICs, PTPs or REITs. In July of 2011, the Service suspended the issuance of additional PLRs addressing the Good Income treatment of commodity-linked instruments and Subpart F/QEF Imputations pending further review.[34]

Later in 2011, Senator Carl Levin, chairman of the Permanent Subcommittee on Investigations and Senator Tom Coburn, the subcommittee's Ranking Minority Member, sent a letter to Douglas Shulman, Commissioner of the Service, that expressed concern about allowing RICs to invest indirectly in commodities (the "**2011 PSI Letter**"). More specifically, they wrote:

> This letter urges the IRS to take immediate action to permanently halt the further issuance of private letter rulings that allow mutual funds to circumvent the income

[30] *See*, I.R.S. Priv. Ltr. Rul. 201605005 (Jan. 29, 2016); I.R.S. Priv. Ltr. Rul. 201503010 (Jan. 16, 2015); I.R.S. Priv. Ltr. Rul. 201431018 (Aug. 1, 2014); I.R.S. Priv. Ltr. Rul. 201314002 (April 5, 2013); I.R.S. Priv. Ltr. Rul. 201129007 (July 22, 2011); s*ee also* I.R.S. Priv. Ltr. Rul. 201431020 (addressing subpart F inclusions but not QEF inclusions).

[31] I.R.S. Priv. Ltr. Rul. 201605005 (Jan. 29, 2016); I.R.S. Priv. Ltr. Rul. 201503010 (Jan. 16, 2015); I.R.S. Priv. Ltr. Rul. 201431018 (Aug. 1, 2014); I.R.S. Priv. Ltr. Rul. 201314002 (April 5, 2013); I.R.S. Priv. Ltr. Rul. 201129007 (July 22, 2011); I.R.S. Priv. Ltr. Rul. 201431020. The Service has also issued PLRs that, under section 856(c)(5)(J), Section 956 Inclusions recognized "on the pledge of the assets of a CFC to secure debt of the [taxpayer] that is used to finance the acquisition of real estate from which income is derived that qualifies under ection 856(c)(2) there is sufficient nexus to treat the Section 956 Inclusion as qualifying income for purposes of section 856(c)(2)." I.R.S. Priv. Ltr. Rul. 201423011 (June 6, 2014). *See also* I.R.S. Priv. Ltr. Rul. 201431020 (Aug. 1, 2014), which holds similarly.

[32] Regulated Investment Company Modernization Act of 2010, Pub. L. No. 111-325, 124 Stat. 3537 (2010).

[33] *See* 156 Cong. Rec. 19179 (2010).

[34] Lee A. Sheppard, *News Analysis: IRS Suspends RIC Commodities Investments Rulings,* 132 Tax Notes 468 (July 28, 2011).

> source restrictions in IRC 851(b)(2) and make unlimited indirect investments in commodities. In addition, the IRS should reevaluate the tax treatment of all mutual funds currently allowed to treat indirect commodity investments as income derived from 'securities' under section 851.[35]

The letter also suggested that the increased volume of investment in commodities markets "may have contributed to distorted prices, price volatility, and hedging failures."[36]

In 2012 the subcommittee held a hearing entitled "Compliance with Tax Limits on Mutual Fund Commodity Speculation" during which Shulman testified that the Service would maintain the letter ruling moratorium until after the Service completed a "fresh look" at all of the relevant issues associated with commodities-related investments by RICs. Shulman also indicated that the moratorium was instated due to the volume of ruling requests and the need to consider published guidance of general applicability.[37] At the hearing Emily McMahon, Acting Assistant Secretary for Tax Policy, reported that Treasury and Service were considering the possibility of issuing published guidance addressing commodity-related investments by RICs and stated, "[t]he extent to which investors should be able to obtain exposure to commodity price fluctuations through investments in RICs is not fundamentally a tax policy issue."[38]

III. DISCUSSION

We are sympathetic with the government's desire to rationalize the meaning of the Imputation/Distribution Rule within the framework of the Good Income Test. The Dividend Proposal does not deviate from a literal application of the Good Income Test and is consistent with our view of how Congress intended for it to be applied.

We do not believe, however, that the Main Proposal reflects how Congress intended for the Imputation/Distribution Rule to operate with the Other Income Provision. In our view, the scope of the Other Income Provision substantially encompasses that of the Imputa-

[35] Letter from Senators Coburn and Levin to Douglas H. Shulman, Re: Private Letter Rulings to Mutual Funds Seeking Commodities Exposure (December 20, 2011) *available at* http://www.hsgac.senate.gov/download/12-20-11-letter-to-irs-from-levin-and-coburn.

[36] 2011 PSI Letter, at 1.

[37] Statement of Douglas H. Shulman, Commissioner of Internal Revenue, in Hearing on "Compliance with Tax Limits on Mutual Fund Commodity Speculation" before the Subcommittee on Investigations at 1-2 (Jan. 26, 2012).

[38] Statement of Emily S. McMahon, Acting Assistant Secretary for Tax Policy, U.S. Treasury Department, in Hearing on "Compliance with Tax Limits on Mutual Fund Commodity Speculation" before the Subcommittee on Investigations at 1–2 (Jan. 26, 2012).

tion/Distribution Rule (except in the narrow case of distributed Subpart F/QEF Imputations from stock *not* held as part of a business of investing in stocks, securities or currencies) and thereby largely renders it deadwood. That Congress expanded the Imputation/Distribution Rule contemporaneously with the adoption of the Other Income Provision does not dissuade us from this view because (i) the historical record relating to the provisions indicates that they were adopted independently of each other and contains no suggestion that Congress intended the Imputation/Distribution Rule to limit the Other Income Provision, (ii) such a limitation would be contrary to the stated purpose of the Other Income Provision and inconsistent with how the provision is applied in analogous contexts and would lead to arbitrary results that we do not believe Congress intended and (iii) under a technical reading of the Good Income Test that gives meaning to each statutory word, the Imputation/Distribution Rule and the Other Income Provision function as independent paths to Good Income treatment. Taking into account all of the foregoing, we believe that this technical interpretation is less strained and thus more consistent with Congressional intent than is the interpretation relied on by the Main Proposal.

A. Historical Account of Congress' Intentions

In 1975, Congress adopted the predecessor to the Imputation/Distribution Rule to serve the sensible purpose of permitting RICs to earn subpart F income as Good Income. The same tax policy rationale for permitting a RIC to earn unlimited amounts of dividends, interest and gain from stocks and securities also justifies treating CFC/PFIC Imputations as Good Income. None of those types of income represents active business income in the hands of the recipient, and all of it generally comes from investing in stocks and securities. The CFC and PFIC rules are intended to prevent tax deferral otherwise available from investments in foreign corporations and are not designed to ensure corporate taxation of active business income.[39] Consistent with that intention, U.S. corporate and non-corporate taxpayers alike are subject to the CFC and PFIC rules. Also consistent with that intention, CFC/PFIC Imputations cannot be treated as income

[39] *See* H.R. Rep. No. 87-1447, at 58 (1962) (stating that the objectives of the CFC regime were: to curb tax deferral by imposing a tax currently on certain income held by Americans abroad; to prevent repatriation of income that is never subject to tax by the U.S.; and to prevent U.S. taxpayers from "taking advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income."); S. Rep. No. 87-1881, at 79 (1962) ("the House bill in general sought to end tax deferral for income derived by U.S. controlled foreign corporations from insurance abroad of U.S. risks; for certain foreign investment income of these corporations; for their income from foreign sales subsidiaries which are separately incorporated from their manufacturing operations; and income invested in 'nonqualified property,' that is, generally, earnings not needed in the same trade or business or funds indirectly brought back to the United States without full payment of U.S. tax.").

effectively connected with a U.S. trade or business and thus taxable in the hands of non-U.S. persons, since those imputations cannot be recognized by non-U.S. persons.

While the Imputation/Distribution Rule advances this policy objective by treating some CFC/QEF Imputations as Good Income, it falls short in two respects. First it excludes from Good Income treatment Section 956 Inclusions and Other CFC Imputations (regardless of their distribution), and second it conditions Good Income treatment of Subpart F/QEF Imputations on their distribution from Current E&P.

We can think of no tax policy justification for those two limitations, and no legislative history suggests a rationale for them. The first seems to have been an oversight that occurred with the 1975 adoption of the predecessor to the Imputation/Distribution Rule. Since Section 956 Inclusions (and Other CFC Imputations) are no less similar to dividends than other subpart F income (all of which come only from investing in stock)[40] and since the recognition of each is designed only to prevent tax deferral by U.S. taxpayers (rather than ensure corporate taxation of business income), there is no reason why they should have been treated differently under the Good Income Test.

The distribution component of the Imputation/Distribution Rule is even more disconnected from any tax policy rationale. That is because the distribution of Subpart F/QEF Imputations is unrelated to determinations about the amount, timing and character of that income in a RIC's hands and unrelated to how the income was earned by the CFC or PFIC. Because a RIC's receipt of distributed Subpart F/QEF Imputations has no relevance to how or when the imputed income is recognized, the distribution of the income cannot be said to bear on the question as to whether a RIC should or should not be limited in how much of that income is treated as Good Income. This tax policy conclusion is the basis, for example, for the MTM PFIC Rule, which treats all mark-to-market income from PFIC stock as Good Income whether or not the PFIC makes a distribution.

Given this disconnect from tax policy, we suspect that the distribution component of the Imputation/Distribution Rule is likely a holdover from the pre-1975 mechanic for determining when a CFC's subpart F income was not required to be recognized. In effect, by imposing this distribution requirement, Congress left RICs in the same place as they were in prior to the 1975 repeal of section 963. In other words, Congress drafted the 1975 predecessor to the Imputation/Distribution Rule so that imputed subpart F income would not be Bad Income in the hands

[40] The legislative history to the 1975 Act acknowledged that the pre-1975 Bad Income treatment of subpart F income was "a problem" and indicated that the predecessor to the Imputation/Distribution Rule was enacted in 1975 to address that problem as well as to prevent its exacerbation from the repeal of section 963. *See* note 8 *supra* and accompanying text.

of RICs that kept doing what they had been doing before 1975 (namely receiving distributions of their share of a CFC's subpart F income).

It is also possible that the distribution component of Imputation/Distribution Rule reflects a sensitivity about the possible characterization of subpart F income as dividends outside of the context of Subchapter M. As now established by *Rodriguez v. Commissioner*,[41] subpart F income and Section 956 Inclusions are not treated as dividend income except as explicitly provided in the Code. In view of the considerations motivating the *Rodriguez* decision, when devising the predecessor of the Imputation/Distribution Rule, Congress perhaps required the distribution of subpart F income in order to tie its dividend treatment under the Good Income Test to an affirmative act instead of the imputation itself. Again, in our view, such a requirement does not reflect sound tax policy, since the distribution is unrelated to the amount, timing or character of the imputed income, but that concern perhaps explains why Congress imposed the distribution requirement in 1975.

We believe that, in 1986, Congress effectively cured these deficiencies inherent in the Imputation/Distribution Rule by adopting the Other Income Provision. That provision's literal language covers all CFC/PFIC Imputations not otherwise treated as dividends under the Imputation/Distribution Rule, since all these imputations come from stock, except in the narrow circumstance in which the stock is held in an active business. While the legislative history to the Other Income Provision does not explicitly address whether Congress intended it to cover or exclude these CFC/PFIC Imputations, its adoption as part of the expansion of the Good Income Test was clearly intended to address similar types of statutory deficiencies, which before 1986 were perceived as inhibiting RICs from fully participating in modern investment strategies.[42] For example, one of the primary motivations for the Other Income Provision was to clarify that gain from a futures contract on a stock index is Good Income because it is derived with respect to the stock underlying the contract, even though the contract is traded on a commodities exchange as a

[41] 137 T.C. 174 (2011).

[42] *See* 131 Cong. Rec. H7701 (statement of Rep. Raymond McGrath) ("[Current rules] inhibit, indeed prevent, the mutual fund industry from using modern investment products and techniques available to the direct investor. Enactment of this bill will change current laws – originally enacted in 1936 – to allow mutual funds to participate fully in the modern age of investment management."); 131 Cong. Rec. H7701 (statement of Rep. Barbara Kennelly) ("This legislation has become necessary largely because of the extensive changes in the financial markets in recent years. These changes include the development of new financial products, such as exchange-traded options, financial futures contracts, and options and futures on stock indexes which have been developed to meet the needs of investors and money managers in the increasingly sophisticated and internationalized economic community in which we live. Certain provisions in subchapter M are simply outdated and unnecessarily restrict the ability of mutual funds to use these new financial products.").

commodity.[43] Similarly, in our view, the Other Income Provision covers CFC/PFIC Imputations because they are derived from stock (except where the stock is held in an active business, *e.g.*, as part of a dealer business).

The stated purpose of the Other Income Provision is to permit RICs to earn unlimited amounts of income *not* treated as dividends, interest or gain from stocks and securities *so long as that other income is also not from an active business*; *i.e.*, so long as it "is derived with respect to [the] business of investing in such stocks, securities, or currencies." [44] That purpose aligns precisely with the more general purpose of Subchapter M, which is to restrict the investment activities of RICs only as necessary to appropriately protect the corporate tax base so as to allow small investors to pool their capital and thereby realize the benefits available to large investors from direct investing.[45] Allowing RICs to earn as part of their investment business unlimited amounts of CFC/PFIC Imputations, whether or not distributed from the CFC or PFIC, advances

[43] *See* 131 Cong. Rec. H 7699 (Sept. 20, 1985) (statement of Rep. Flippo) (discussing the need to modernize the interpretation of qualifying income and stating "that gains from options and futures contracts related to a fund's portfolio investments constitute qualifying income.") *See* also Statement of Dennis E. Ross, Tax Legislative Counsel, U.S. Treasury Department, in "Hearings on Issues Relating to Passthrough Entities" before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means at 136 (June 10, 1986) ("Despite the apparent inflexibility of the Code, the Internal Revenue Service has often gone beyond the literal terms of the statute to give a reasonable interpretation to the income source rules. For example, the Internal Revenue Service has ruled privately that certain investment products such as options and futures contracts on securities, which are not specifically listed in the Code, will be treated as securities, gains from the sale or disposition of which constitute permitted income.")

[44] The stated purpose of the Good Income Test, which is first to restrict a RIC's income to that of an investment business and second to restrict such income to that of assets specified in the Other Income Provision, is thereby self-contained within the Other Income Provision itself. *See* note 18 and accompanying text.

[45] The fundamental purpose of Subchapter M is to permit small investors to obtain the benefits of professional management and diversified investing available to large investors by allowing them to invest pooled funds without having to bear a corporate tax. This policy has been reiterated through Subchapter M's history, starting with the enactment of its predecessor in 1936 and continuing through to the 198 6 Act (as noted in the 2011 PSI Letter). *See* Statement of Paul C. Cabot and Merrill Griswold representing State Street Investment Corporation, Boston, Massachusetts before the Senate Finance Committee in June, 1936 (discussing the importance of investment trusts to "persons of moderate means, who do not have equal facilities with the wealthy to obtain expert supervision and diversity in their investments" in relation to the Revenue Act of 1936, Pub. L. No. 74-740, 49 Stat. 1648); 132 Cong. Rec. 4046 (Remarks of Sen. Armstrong) (Mar. 7, 1986) ("the results of [this bill] will afford mutual fund managers the opportunity to make investment decisions that accommodate today's marketplace to act in the best interest of the mutual fund shareholder, and to provide the shareholder, typically a middle-income American, the same investment opportunities that are available to the direct investor.") The requirements for RIC qualification, as indicated by the stated purpose of the Good Income Test, are designed gen-generally to prevent RICs from being used to conduct active businesses.

Subchapter M's general purpose of promoting flexibility in how RICs conduct their investment business consistent with the protection of the corporate tax base.

Since CFC/PFIC Imputations are recognized only from stock, they are even more tightly connected with the business of investing in stock than is the type of income covered explicitly by the Other Income Provision, which comes from derivatives and is Good Income only because stock or securities underlie the derivatives. In addition, the Service has found that the Other Income Provision covers other types of income with a more attenuated connection to the ownership of stock and securities, such as expense reimbursements;[46] income from non-traded derivatives on securities,[47] constant maturity swaps, consumer price index swaps, and interest rate swaps;[48] settlements from investment losses;[49] commodity hedges on stocks;[50] and royalties and net profits interests received from making loans.[51] Being derived directly from stock, CFC/PFIC Imputations fit more easily within the literal words of the Other Income Provision than does the income from any of these other types of investment activity.

The only remaining question is why Congress preserved and expanded the Imputation/Distribution Rule in 1986 to include distributed QEF Imputations if it intended the Other Income Provision to cover CFC/PFIC Imputations. We suspect the reason is that the changes to the Imputation/Distribution Rule came from draft legislation that was prepared separately and independently of the draft legislation that included the Other Income Provision and that in the process of stitching together these pieces of draft legislation into the final 1986 Act Congress gave no consideration to how the two provisions should interact.[52] As a technical amendment, the extension of the Imputation/Distribution Rule was non-substantive and, we therefore believe, does not reflect an intention to substantively restrict the Other Income Provision. That extension was contained in the international provisions of the 1986 Act (specifically section 1235(f)), while the Other Income Provision was included in the subchapter M provisions (specifically section 653(b) of the 1986 Act, 277 pages earlier). In our view, Congress would have likely eliminated

[46] Rev. Rul. 92-56, 1992-2 C.B.153.

[47] I.R.S. Priv. Ltr. Rul. 201319003 (May 12, 2013).

[48] I.R.S. Priv. Ltr. Rul. 201103036 (Jan. 21, 2011).

[49] I.R.S. Priv. Ltr. Rul. 200739010 (Sept. 28, 2007).

[50] I.R.S. Priv. Ltr. Rul. 200652013).

[51] I.R.S. Priv. Ltr. Rul. 200532032 (Aug. 12, 2005).

[52] The Other Income provision was introduced on June 24, 1986 in the Senate, while the change the Imputation/Distribution Rule was made as a technical amendment by the House on September 18, 1986. The 1986 Act was passed by the House on September 25, 1986 and by the Senate on September 27, 1986 and signed by the President on October 22, 1986.

the rule if it had considered the rule's continuing relevance after the enactment of the Other Income Provision.

In no event do we believe that Congress intended the Imputation/Distribution Rule to serve as an exception to the Other Income Provision. That is because the limitations inherent in the Imputation/Distribution Rule are incoherent, advance no tax policy of their own and are inconsistent with the tax policies that Congress explicitly identified as the underpinnings of the 1986 reforms that the Other Income Provision was designed to implement. To interpret the Imputation/Distribution Rule as an exception to the Other Income Provision would undermine those stated policies in contravention of Congress' expressed intent. This conclusion is also supported by the legislative process involving the passage of the RIC Modernization Act, which contained no suggestion that anyone in Congress disagreed with the holdings of the PLRs treating CFC/PFIC Imputations as Good Income under the Other Income Provision.

Our conclusion is perhaps best supported, however, by the arbitrary results that would potentially occur from limiting the Other Income Provision by the Imputation/Distribution Rule. In view of the Other Income Provision's expressed purpose, we do not believe that Congress intended to cause these results, as illustrated by the following examples:

i. Assume a RIC can control the timing of a CFC's distributions but is unable to accurately determine its subpart F income before its year end. Recognizing the challenges of determining income for a year before the year's close, in rules adopted in 1986 Congress allows RICs to use the 12-month period ending in October for purposes of measuring its capital gain income that must be distributable before the calendar-year end. If Congress intended to require contemporaneous Subpart F/QEF Imputations and distributions after 1986, it would have presumably adopted a rule allowing for some grace period between the end of the measurement period for the income and the deadline for distributing the income.

ii. Assume a RIC wants to invest in a CFC but cannot persuade the issuer to commit to distributing Current E&P. The CFC might be unable to make that commitment because of its own capital requirements or because of legal restrictions such as covenants to its lenders. It seems unlikely that Congress would have intended for the Good Income treatment of income from the investment to depend on the RIC's ability to secure a promise from the CFC to make adequate distributions since the CFC's reasons for not distributing Current E&P would be unrelated to tax considerations of the RIC.

iii. Assume a RIC wants to invest in a CFC, but because the CFC that has already made distributions in excess of its expected subpart F income for the year, it would be im-

possible for the CFC to fully distribute its subpart F income in the form of Current E&P after the RIC's investment. It seems unlikely that Congress would have intended for Subpart F/QEF Imputations to a RIC to be necessarily and always Bad Income by reason of distributions Current E&P prior to the RIC's investment in the CFC.

iv. Assume a RIC invests in a PFIC but cannot be assured of current distributions. To protect itself from recognizing Bad Income the RIC would have to rely on the MTM PFIC Rule, which would result in all ordinary treatment of the income from the PFIC, contrary to how direct investors would be able to recognize income from the PFIC and thus contrary to subchapter M's purpose of allowing small investors the benefits of direct investing that are available to large investors.

B. Rationale for the Main Proposal

The Main Proposal would treat as Bad Income undistributed Subpart F/QEF Imputations along with distributed and undistributed Other CFC Imputations derived from a RIC's investment business. The preamble to Proposed Regulations § 1.851-2(b) suggests that the statutory language of section 851(b) compels this result. More specifically, it states that treating CFC/PFIC Imputations as covered by the Other Income Provision "ignores the requirement in section 851(b) that amounts be distributed in order to treat these inclusions as dividends." It continues:

> This distribution requirement is a more specific provision than the other income clause. In addition, it cannot be suggested that the distribution requirement was superseded by the other income clause because the other income clause and the distribution requirement for inclusions under section 1293(a) were both added by the 1986 Act. Therefore, these proposed regulations specify that an inclusion under section 951(a)(1)(A)(i) or 1293(a) is treated as a dividend for purposes of section 851(b)(2) only to the extent that the distribution requirement in section 851(b) is met. These proposed regulations further provide that, for purposes of section 851(b)(2), an inclusion under section 951(a)(1) or 1293(a) does not qualify as other income derived with respect to a RIC's business of investing in stock, securities, or currencies.[53]

This interpretation of section 851(b) appears to be based on the negative inference that, because the Imputation/Distribution Rule specifically addresses the Good Income treatment of distributed Subpart F/QEF Imputations, the Other Income Provision is preempted from extending

[53] 81 Fed. Reg. 66577 (2016)

Good Income treatment to any CFC/PFIC Imputations. The view that this negative inference is dispositive appears to be based on a doctrine of statutory interpretation concluding that "a specific statute controls over a general one."[54] The purpose of this doctrine is to infer legislative intent.[55] The doctrine does not apply, however, to the extent that the two provisions are consistent with each other.[56]

Read technically, the Imputation/Distribution Rule and Other Income Provision are consistent with each other in the sense that the latter includes the former, except when the CFC or PFIC stock is not held in an investment business. Under this reading, each provision constitutes an independent basis for treating the imputations as Good Income. In particular, for Good Income treatment, the Imputation/Distribution Rule requires a distribution and relies on the imputed income being treated as a dividend, which means the income need not be derived with respect to an investment business (and for example could come from dealer activity); whereas, the Other Income Provision requires the income to be derived from an investment business but does not require a distribution (the "**Technical Interpretation**"). Under this Technical Interpretation, no negative inference can be drawn about the Imputation/Distribution Rule being the exclusive basis for Good Income treatment of CFC/PFIC Imputations.

The only shortcoming of the Technical Interpretation is that it implies that Congress intentionally preserved and expanded the Imputation/Distribution Rule in order to permit RICs to recognize CFC/PFIC Imputations from an active business and thereby treat those imputations as it does actual dividends, interest and gain from stocks and securities. Nothing in the historical record supports this inference, and given the legislative record, such an intricate and nuanced interaction between the two provisions seems unlikely to have been intended. As discussed, the

[54] *See, e.g.*, Bulova Watch Co., Inc. v. United States, 365 U.S. 753, 758 (1961) ("it is familiar law that a specific statute controls over a general one 'without regard to priority of enactment'").

[55] *See* al-Marri v. Pucciarelli, 534 F.3d 213, 241 (4th Cir. 2008), *vacated and remanded sub nom.* al-Marri v. Spagone, 555 U.S. 1220, 129 S. Ct. 1545, 173 L. Ed. 2d 671 (2009) (stating, in a footnote, that the "Supreme Court has long directed that courts follow the 'well settled rule' that a specific statute controls over a general one as a means to ascertain legislative intent.") (*quoting* Townsend v. Little, 109 U.S. 504, 512 (1883)).

[56] *See e.g.*, United States v. Bair, 221 F.Supp. 171, 173 (explaining that the rule that a specific provision controls a general provision is subject to certain qualifications and would not apply, for example, where the specific provision is consistent with the general provision); Atl. Richfield Co. v. Farm Credit Bank of Wichita, 226 F.3d 1138 (10th Cir. 2000) (stating that the rule that a specific provision controls a more general one does not apply where there is no inherent conflict between the two provisions); Sanchez v. Ameriquest Mortgage Co., 372 B.R. 289 (Bankr. S.D. Tex. 2007) (stating that a specific provision will control a more provision to "the extent they conflict"); Adirondack Med. Ctr. v. Sebelius, 740 F.3d 692, 408 U.S. App. D.C. 161 (D.C. Cir. 2014) (stating, with respect to the rule that a specific provision controls over a more general provision, that such "canon is impotent, however, unless the compared statutes are 'irreconcilably conflicting.'").

more likely actual explanation is that Congress did not consider the post-1986 relevance of the Imputation/Distribution Rule.

We nevertheless believe, however, that the Technical Interpretation represents a less implausible account of Congressional intent than does the interpretation relied on by the Main Proposal. That is because the effect of the Technical Interpretation is more consistent with our understanding of Congress' intent for the Other Income Provision. Using the Imputations/Distribution Rule to limit the Other Income Provision would serve no identifiable tax policy, would be inconsistent with its other applications and would undermine the stated purpose of the Other Income Provision, which is to allow investment flexibility consistent with the protection of the corporate tax base.

The Technical Interpretation avoids these results by giving meaning to each word of the Good Income Test to support treating the two provisions as being consistent with each other. In our view, this interpretation is more compelling because treating the two provisions as consistent with each other is also more consistent with the Other Income Provision's expressed purpose and other applications and avoids the arbitrary results of the Main Proposal. Given this, we believe that it would be a strain to conclude, solely on the basis that the Imputation/Distribution Rule is more "specific" than the Other Income Provision, that Congress intended for Imputation/Distribution Rule to limit the Other Income Provision, especially since that conclusion is inconsistent with the statute's actual words. On that basis, we recommend that the Main Proposal not be adopted and that final regulations treat as Good Income all CFC/PFIC Imputations derived with respect to a business of investing in stocks, securities or currencies.

C. Alternative Justifications for the Main Proposal

Some practitioners have speculated that, notwithstanding the explanation provided in the Notice, the Main Proposal might be intended to discourage RICs from investing in CFCs and PFICs that trade commodities, perhaps in response to the 2011 PSI Letter and subsequent hearings. Many of the RICs affected by the Main Proposal own CFCs that trade in commodities, and the PLRs treating CFC/QEF Imputations as Good Income were granted to such RICs. The income from those commodities, if recognized directly by a RIC, would have been Bad Income, and these RICs avoid corporate tax on such income by conducting their commodities trading activities through offshore subsidiaries.

We are skeptical, however, that Congress intended for the Imputation/Distribution Rule to be used as a tool for policing RICs' indirect investing in commodities. In 2004, Congress codified the ability of RICs to invest indirectly in commodities by expanding the Good Income Test to cover all income from QPTPs, including income from trading commodities. This result is con-

sistent with McMahon's testimony that limiting investors exposure to commodity price fluctuations through RIC investments is not fundamentally a tax policy issue.[57]

Although in 2010 the Commodity Proposal was excluded from the RIC Modernization Act, neither the amendments removing that proposal nor any of the other proposals introduced as part of the consideration and passage of that Act would have either (i) restricted RICs from investing in QPTPs with commodities income or (ii) reversed the holdings of the previously issued PLRs that permitted RICs to invest indirectly in commodities, including the holding that undistributed Subpart F/QEF Imputations qualify as Good Income. This record does not support an inference that Congress objects to RICs indirectly investing in commodities.

Regardless, however, of whether Congress intended for RICs to be permitted to invest indirectly in commodities, we do not believe that the Main Proposal can be justified as an effort to discourage such investments because it fails to do that. The Main Proposal (i) does not limit the amount of distributed Subpart F/QEF Imputations attributable to commodities and (ii) is not limited to CFC/QEF Imputations from commodities. Other types of CFC/QEF Imputations, such as dividends and interest, would be clearly good if earned directly by a RIC, just as still other types of such imputations, such as foreign based company services income (or any business income in the case of QEF Imputations), would be clearly bad. Under the Main Proposal, CFC/QEF Imputation attributable to "good" sources such as dividends and interest would be Bad Income if undistributed (or if Other CFC Imputations), and Subpart F/QEF Imputations attributable to "bad" sources would be Good Income if distributed.

Nothing about the structure or effect of the Imputation/Distribution Rule suggests that Congress intended the rule to regulate a RIC's ability to earn subpart F income attributable to commodities trading or other types of Bad Income. Moreover, the Main Proposal would have little or no consequence to RICs heavily involved in indirect commodity trading and a potentially large and adverse consequence to other RICs and PTPs. That is because RICs with large indirect commodities exposure typically obtain that exposure through controlled subsidiaries from which they can easily extract distributions for the purpose of treating the imputed commodities-derived income as Good Income. By contrast, other RICs that invest in CFCs or PFICs are less likely to control those issuers and therefore are less able to require those issuers to distribute the Subpart F/QEF Imputations, including when the imputations are unrelated to commodities. Those RICs and PTPs with less commodities exposure are thereby more limited in how they can invest.

In addition, adopting the Main Proposal would have the collateral consequence of restricting PTPs from investing indirectly in commodities through CFC or PFICs even though

[57] *See* note 38.

commodities gain earned directly from a principal activity of commodities trading would qualify as PTP Good Income. In the case of PFIC investments, PTPs would also be less able to avoid these adverse consequences than would RICs, since RICs but not PTPs could treat non-traded PFICs as marketable and, by electing to mark-to-market the stock of those PFICs, treat the resulting gain as Good Income under the MTM PFIC Rule. For all these reasons, the Main Pro-Proposal should not be adopted on the grounds that it advances a tax policy of limiting the ability of RICs to invest indirectly in commodities, even if that were a tax policy of Subchapter M.

If policymakers determine that RICs should be restricted from investing indirectly investing in commodities, a more effective way to do that would be to treat distributed and undistributed subpart F income and QEF Imputations as Bad Income to the extent attributable to commodities. We do not believe, however, that there is any statutory basis for adopting such a rule by regulation, since it would be clearly contrary to the plain language of section 851(b)(2)(A), which specifically provides that distributed Subpart F/QEF Imputations qualify as Good Income and does not limit that conclusion to imputations unrelated to commodities. For that reason, if policy makers determine that RICs should not be permitted to indirectly invest in commodities through subsidiaries, then Congress should enact legislation so limiting RICs, and the limitation should apply to investments in QPTPs and PFICs subject to a mark-to-market election as well as investments in CFCs and PFICs subject to a QEF election.