

Part I

Section 851.—Definition of Regulated Investment Company

26 CFR 1.851-2: Limitations

(Also Sections 7704, 7805; 301.7805-1.)

Rev. Rul. 2006-31

Rev. Rul. 2006-1, 2006-2 I.R.B. 261, discusses derivative contracts with respect to a commodity index (“Derivatives”) that a regulated investment company (R) enters into under Master Agreements with various counterparties. Under the Derivatives, R will pay an amount equal to the 3-month U.S. Treasury bill rate plus a spread and will receive (or pay) an amount based on the total return gain (or loss) on a commodity index. The payment obligation on each Derivative is settled monthly by the receipt (in the event of a gain) or payment (in the event of a loss) of cash, in the net amount under the contract, and each monthly measuring period constitutes a separate derivative contract under the Master Agreements.

Rev. Rul. 2006-1 holds that a derivative contract with respect to a commodity index is not a security for purposes of section 851(b)(2) of the Internal Revenue Code and that, under the facts stated in the ruling, R’s income from the contract is not qualifying income for purposes of section 851(b)(2), because the income from the contract is not derived with respect to R’s business of investing in stocks, securities, or currencies. Rev. Rul. 2006-1 further provides that under the authority of section 7805(b)(8), the holding of the revenue ruling will not be applied adversely with respect to amounts of income that a taxpayer recognizes on or before June 30, 2006.

It has come to the attention of the Service that some taxpayers are questioning whether the holding of the revenue ruling applies to investments by regulated investment companies (RICs) in all derivative contracts with respect to a commodity index, including for example structured notes, rather than just to the Derivatives described in the revenue ruling.

The ruling was not intended to preclude a conclusion that the income from certain instruments (such as certain structured notes) that create a commodity

exposure for the holder is qualifying income under section 851(b)(2). Accordingly, to clarify the holding of Rev. Rul. 2006-1, the HOLDING section is revised to read:

A Derivative is not a security for purposes of section 851(b)(2). Under the facts above, R's income from a Derivative is not qualifying income for purposes of section 851(b)(2), because the income from the contract is not derived with respect to R's business of investing in stocks, securities, or currencies.

In addition, some taxpayers have questioned whether the prospective application of the ruling is limited to the Derivatives described in the revenue ruling or includes all derivative contracts with respect to a commodity index or an individual commodity, including, for example, commodity futures contracts. The Service has also been informed that, due to temporary demand/supply imbalances, some RICs that had previously invested in derivative contracts similar to the Derivatives described in Rev. Rul. 2006-1 are having difficulty in acquiring alternative commodity-linked investments that result in qualifying income for purposes of section 851(b)(2).

The prospective application of the ruling was intended to apply to all derivative contracts with respect to a commodity index or an individual commodity. Accordingly, to alleviate temporary supply/demand pressure and to clarify the scope of the PROSPECTIVE APPLICATION section of Rev. Rul. 2006-1, that section is revised to read:

Under the authority of section 7805(b)(8), the holding of this revenue ruling will not be applied adversely with respect to amounts of income that a taxpayer recognizes on or before September 30, 2006, from a Derivative. Neither will the Service apply the principles set forth in this revenue ruling adversely with respect to amounts of income recognized on or before September 30, 2006, by a taxpayer from a derivative contract (including an option, futures or forward contract) on a commodity index or an individual commodity.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 2006–1 is modified and clarified.

DRAFTING INFORMATION

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