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A Tale of Two "Pauses": The IRS's Halt in Issuing Private Letter Rulings for MLPs and RICs — An Analysis of the Challenges of Determining Qualifying Income and Structuring Considerations For MLP RICs

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"Whenever you find yourself on the side of the majority, it is time to reform (or pause and reflect)." [1]

I. INTRODUCTION

The IRS Office of Associate Chief Counsel, Passthroughs and Special Industries, recently announced the lifting of its self-imposed ''pause'' in issuing private letter rulings (PLRs) to certain master limited partnerships (MLPs).[2] The pause had been in effect for approximately one year (the MLP Pause).[3] The IRS also confirmed that proposed regulations are expected to follow, which will provide guidance concerning qualifying income from services under §7704.[4] The MLP Pause stands in stark contrast to another self-imposed IRS ''pause'' in issuing certain PLRs for regulated investment companies (RICs) involving commodity-based investments; a pause that has remained in effect for almost four years (the RIC Commodity Pause).[5] Although these two recent IRS ''pauses'' are not directly related to one another, there are parallels between them that highlight the challenges facing both the IRS and practitioners when determining ''qualifying income'' for passive investment vehicles. This article will provide background on the underlying tax issues likely causing both ''pauses'' and then analyze the unique challenges currently facing the IRS as it works toward lifting the RIC Commodity Pause. Finally, this article will examine the statutory cross-references regarding qualifying income for RICs and publicly traded partnerships and offer tax-structuring considerations for RICs that predominately invest in MLPs.

II. THE MASTER LIMITED PARTNERSHIP PAUSE

A. Legislative Background

In the early 1980s, businesses with active operations increasingly began forming as partnerships to secure favorable tax treatment, and registering their limited partnership interests to the public on an exchange or over the counter.[6] Limited partnerships with an active business whose interests were traded on an established securities market in a similar manner to corporate stock became known as MLPs.[7] MLPs, classified as partnerships for U.S. federal in-

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[1] Mark Twain, *Notebook*, 1904.

[2] *See generally* Matthew R. Madara, *IRS Announces Resumption of PTP Letter Rulings*, 2015 TNT 45-4 (Mar. 9, 2015).

[3] Amy S. Elliott, *IRS Has Stopped Ruling on Publicly Traded Partnership Qualifying Income*, 2014 TNT 61-4 (Mar. 31, 2014) (quoting Clifford Warren, Special Counsel in the IRS Office of the Associate Chief Counsel (Passthroughs and Special Industries), stating that '' '[i]ssued a moratorium' I think overstates it. It's nothing that formal. But we have what officially we call a pause'').

[4] Matthew R. Madara, *IRS Announces Resumption of PTP Letter Rulings*, 2015 TNT 45-4 (Mar. 9, 2015).

[5] Lee A. Sheppard, *News Analysis: IRS Suspends RIC Commodities Investments Rulings*, 2011 TNT 145-1 (July 28, 2011).

[6] Joint Committee on Taxation, *Taxation of Master Limited Partnerships* (JCS-19-87) at 21 (July 20, 1987).

[7] *Id.* at 22.

come tax purposes, are only subject to a single level of tax at the partner level, with deductions from the MLP also flowing through to the partners to offset any taxable income from the MLP.[8] The first industries to utilize this tax structure were real estate and natural resource firms, but it did not take long for businesses in other industries to catch on to the unique advantages of forming an MLP.[9]

Congress took notice of the trend toward MLP formation, especially in the wake of the Tax Reform Act of 1986[10] and the repeal of the *General Utilities* doctrine.[11] The 1986 tax reforms made passthrough vehicles much more attractive to businesses, and Congress was concerned that allowing passthrough entities to continue enjoying partnership income tax treatment (i.e., no entity-level tax) would facilitate mass circumvention of the corporate-level tax that the Tax Reform Act of 1986 had fought to preserve.[12] Finding that MLPs very closely resembled publicly traded corporations, Congress added §7704 to the Internal Revenue Code (''the Code''),[13] in the Omnibus Budget Reconciliation Act of 1987, reclassifying certain publicly traded partnerships as corporations for federal income tax purposes.[14]

B. Section 7704

1. In General

As a general rule, §7704 provides that a publicly traded partnership (''PTP'')[15] will be classified as a corporation for U.S. federal income tax purposes unless the partnership meets certain exceptions.[16] In enacting §7704, Congress found many similarities between corporations and PTPs, but the definitive characteristic that Congress found to be indicative of a need for corporate tax treatment was the public trading of limited partnership interests.[17] As such, the Code defines a PTP as any partnership whose interests are either (i) traded on an established securities market, or (ii) readily tradable on a secondary market (or the substantial equivalent thereof).[18] Partnership interests are ''readily tradable on a secondary market or substantial equivalent thereof''[19] if ''taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.''[20] Note that the IRS and the Department of the Treasury (''Treasury'') have provided several regulatory safe harbors that further clarify whether or not a partnership's interests are readily tradable on a secondary market.[21] The safe harbors include bright-line rules that bring some certainty to the tax classification of PTPs.[22]

2. Section 7704(c) — The Exception for Passive-Type Income

For entities that cannot fit themselves within any of the trading safe harbors, §7704(c) also provides an exception to corporate tax treatment for PTPs with passive types of income, or for certain types of businesses that were historically conducted in partnership form.[23] In order for a business to benefit from the exception under §7704(c), 90% or more of its gross income for the current and all preceding taxable years beginning December 31, 1987 must consist of qualifying income.[24] Section 7704(d)(1) lists seven specific categories of qualifying income that generally include passive sources of income such as interest, dividends, and real property rents, and income and gains from commodities, futures, etc.

a. The 1940 Act Exception and Commodities Income

Of particular note for the latter half of this article, §7704(c)(3) also contains an exception that provides that the qualifying income exception in §7704(c)(2) does not apply to a PTP that would be described in

[8] *Id.* at 21.

[9] Robert J. Leonard, *A Pragmatic View of Corporate Integration*, 35 Tax Notes 889, 896 (June 1, 1987) (noting that before 1986, only four of the 41 formed MLPs were not in the real estate or natural resource industry, but the number of non-real estate or energy industry MLPs jumped to 19 by 1987).

[10] Pub. L. No. 99-514.

[11] Under the *General Utilities* doctrine, a corporation recognized no gain or loss on the distribution of appreciated property to its shareholders. *See Gen. Utils. v. Helvering*, 296 U.S. 200 (1935). Section 311(b) imposes tax on any built-in gain on a corporation's distribution of appreciated property in a taxable transaction.

[12] H.R. Rep. No. 100-391, pt. 2, at 1065–66 (1987).

[13] Unless otherwise stated, all section or ''§'' references are to the Internal Revenue Code of 1986, as amended, and ''Reg. §'' refers to the Treasury regulations thereunder.

[14] Pub. L. No. 100-203, title X, §1021(a), 101 Stat. 1330-403 (1987).

[15] Note, MLPs are a subset of PTPs. An MLP is a PTP that operates an active business while enjoying partnership tax treatment by satisfying the qualifying income exception under §7704(d). MLPs are typically organized as Delaware limited partnerships; although they can be organized as limited liability companies. Any reference in this article to PTPs also includes MLPs.

[16] §7704(a).

[17] H.R. Rep. No. 391, 100th Cong., 1st Sess. (1987) stating: ''the committee concluded that public trading involves a degree of lack of identity of the investor with the entity that particularly justifies separate taxation of the entity, rather than partnership conduit treatment.''

[18] §7704(b).

[19] *Id.*

[20] Reg. §1.7704-1(c)(1).

[21] *See generally* Reg. §1.7704-1(e) – §1.7704-1(j). The provisions of these safe harbors are beyond the scope of this article; however, these safe harbors are very useful for many entities seeking to be classified as partnerships for U.S. federal income tax purposes.

[22] *Id.*

[23] Note also that §7704(g) delayed the effective date of §7704 for certain ''electing 1987 partnerships'' by 10 years.

[24] §7704(c)(2).

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§851(a) (i.e., a RIC) if the PTP were a domestic corporation. Effectively, this means that a PTP that is required to register under the Investment Company Act of 1940 (the 1940 Act) (e.g., an entity principally engaged in the business of investing, reinvesting, or trading in securities)[25] must comply with the subchapter M rules applicable to RICs, and must be taxed as a corporation. Note that §7704(c)(3) contains an exception-to-the-exception for any partnership whose principal activity is the buying and selling of commodities (not described in §1221(a)(1)), or options, futures, or forwards with respect to commodities (i.e., a commodity pools).[26] Note, however, this exception-to-the-exception is prefaced by the phrase ''to the extent provided in regulations,'' and the IRS has never issued such regulations.[27] It should also be noted that §7704(d)(1)(G) enumerates ''income and gains from commodities (not described in §1221(a)(1)) or futures, forwards, and options with respect to commodities'' as qualifying income.

b. Qualifying Income from RICs and REITs

It is also worth mentioning for purposes of the latter half of this article, that §7704(d)(4) provides that qualifying income also includes income that would qualify under the RIC qualifying income rules of §851(b)(2)(A) and the real estate investment trust (REIT) qualifying income rules of §856(c)(2). Congress intended that qualifying income for PTPs should include passive income sources or income from activities that had typically been conducted in pass-through form, thus Congress deemed it appropriate to cross-reference the predecessor RIC and REIT qualifying income tests.[28]

c. Section 7704(d)(1)(E) — The Natural Resource Exception

The MLP Pause referenced above applies to certain PLR requests concerning the scope of qualifying income under §7704(d)(1)(E) (the Natural Resource Exception).[29] The Natural Resource Exception provides that certain natural resource-related activities produce qualifying income, which includes:

> Income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of any fuel described in subsection (b), (c), (d), or (e) of section 6426, or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as defined in section 40A(d)(1).[30]

It is generally understood that §7704(d)(1)(E) can be broken down into a two-part test to determine whether or not an activity would qualify for the Natural Resource Exception; determining first whether or not the income is derived from a qualifying natural resource and second whether the activity generating the income qualifies under the exception.[31] According to §7704(d)(1)(E), a qualifying resource is ''any mineral or natural resource . . . industrial source carbon dioxide, or . . .any fuel described in (b), (c), (d), or (e)'' (i.e., renewable energy and alternative fuels). In addition, the flush language to §7704(d)(1) defines ''mineral or natural resources'' as ''any product of a character with respect to which a deduction for depletion is allowable under section 611'' (i.e., mines, oil and gas wells, other natural deposits, and timber). [32]

Based upon the Congressional statements accompanying the 1988 additions to §7704(d)(1)(E), it is now recognized that ''qualifying income does not include, for example, income from fishing, farming . . . hydroelectric, solar, wind, or nuclear power production.''[33] The IRS apparently views this list to be illustrative of the fact that income from certain inexhaustible natural resources, including soil, sod, dirt, tuff, water, mosses, minerals from sea water, and air, will not be deemed to be qualifying income for purposes of this exception.[34] Note that §7704(d)(1)(E) specifically identifies ''gas, oil, or products thereof'' and ''fertilizer, geothermal energy, and timber,'' as qualifying natural resources.

Once it is determined that the resource in question is a qualifying natural resource, the analysis generally turns to the nature of the income-producing activity. Section 7704(d)(1)(E) lists exploration, development, mining or production, processing, refining, transportation (including pipelines) or marketing of natural resources, as well as the transportation or storage of certain other resources[35] as qualifying activities. Processing and refining are qualifying activities, subject to

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[25] 15 U.S.C. §80a-3(a)(1)(A). Note, however, subsections 3(a)(1)(B) and (C) of the 1940 Act include additional entities within the definition.

[26] Conf. Rep. No, 100-495, 100th Cong, 1st Sess., 1987-3 C.B. 193 at 226.

[27] Some commentators have asserted that it is unclear whether or not this commodity carve-out should be regarded as self-executing. *See, e.g.,* Lay, Sloan, & Sutton, 723 T.M., *Publicly Traded Partnerships*, at II.D.2.g.(2).

[28] H.R. Rep. No. 100-391, pt. 2, at 1066–67 (1987).

[29] *See* Elliot, n. 3 above. Note, however, representatives from the IRS publicly acknowledged that the ''pause'' was not necessarily limited to the natural resource area, but that most of the PLR requests tended to be in this area.

[30] §7704(d)(1)(E).

[31] Lay, Sloan, & Sutton, n. 27 above, at II.D.2.f.(1).

[32] Note that certain other sources are excluded from the category of qualifying resources, including soil, sod, dirt, turf, water, mosses, minerals from sea water, the air, or similar inexhaustible sources. §613(b)(7)(A) and §613(b)(7)(B).

[33] S. Rep. No. 100-445 at 424 (1988).

[34] *See, e.g.,* PLR 200821021.

[35] Fuels described in subsection (b), (c), (d), or (e) of §6426, or any alcohol fuel defined in §6426(b)(4)(A) or any biodiesel fuel as defined in §40A(d)(1), largely renewable resources.

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the limitation that ''[o]il, gas, or products thereof are not intended to encompass oil or gas products that are produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives.''[36]

With respect to transportation, whether or not an activity qualifies for the §7704(c) exception from corporate tax treatment depends upon the mode of transportation and the customer to whom the resource is being delivered.[37] Generally, if the resource is being delivered by pipeline, all income derived therefrom will be qualifying.[38] If the resource is being delivered by any other method (truck, ship, etc.), then it becomes necessary to look at the customer. If the customer to whom the resource is being delivered is a ''retail customer,'' then generally income derived from transporting the resource will not be qualifying.[39] A similar ''retail exception'' applies to the marketing of natural resources, pursuant to which income derived from marketing minerals and natural resources to end users that are ''retail customers'' generally will not be considered qualifying income (e.g., gas station operations).[40] Because the exact contours of the above qualifying activities are not always clearly defined, many taxpayers relying on the Natural Resource Exception to qualify an MLP as a partnership for federal income tax purposes, have requested a PLR from the IRS regarding whether their specific business operations generate qualifying income.

C. The MLP Pause

1. Background on the IRS, PLRs for MLPs/PTPs

While the enactment of §7704 may have curtailed the use of the PTP structure for many industries, the Natural Resource Exception clearly provided an excellent opportunity for businesses with operations directly related to natural resources to form MLPs classified as partnerships for U.S. federal income tax purposes. The challenge faced by MLPs, is that because §7704(d)(1)(E) and the accompanying legislative history enumerate specific activities that generate qualifying income, engaging in unenumerated activities requires a high level of confidence that such activities are sufficiently related to the statutorily listed activities to fall within the Natural Resource Exception.

Because many MLPs offer their limited partnership interests to the broader public, their partnership interests are likely deemed ''traded on an established securities market or readily tradable on a secondary market,'' thereby excluding them from the trading safe-harbors of Reg. §1.7704-1. Consequently, publicly offered MLPs need full assurances that their activities satisfy the qualifying income exception of §7704(c)(1) to be classified as a partnership. For example, in the author's experience, an MLP that registers its limited partnership interests (generally referred to as ''units'' or ''common units'') will likely be required to secure a ''will'' level opinion that the MLP is classified and taxed as a partnership. Accordingly, the determination under §7704(d)(1)(E) of whether an MLP will generate sufficient amounts of qualifying income becomes critically important to the entity classification of the MLP.

One of the easiest ways to arrive at the high level of assurance needed for the public offering of an MLP that engages in activities that are not specifically listed in §7704(d)(1)(E), is to secure a PLR from the IRS blessing those activities. A key point to bear in mind is that because a PLR is the IRS's opinion based on the facts and circumstances particular to one taxpayer, other taxpayers with similar facts cannot technically rely upon an issued PLR as precedent, nor does a PLR bind the IRS to take similar positions in the future.[41] The personalized nature of PLRs, however, gives the requesting MLP taxpayer comfort and confidence that they can move forward with their proposed transaction or business plan without worrying that the IRS will subsequently reclassify the MLP as a corporation for U.S. federal income tax purposes.

2. The Natural Resource Exception PLRs — In General

It appears, that as the number of energy-related corporations using the MLP model increased, so did the number of PLRs issued under the Natural Resource Exception.[42] Over the 17-year period between 1989 and 2006, the IRS issued only 31 PLRs under the Natural Resource Exception, a rate of roughly two PLRs per year. However, between 2007 and 2012, the IRS issued 46 PLRs under the Natural Resource Exception,[43] with a remarkable 18 PLRs issued in 2012 alone.

The dramatic increase in the number of PLRs issued under the Natural Resource Exception not only demonstrates the appeal of the MLP model to businesses in the natural resources industry,[44] but also the self-fulfilling nature of the issuance of PLRs. As mentioned above, taxpayers cannot rely on PLRs issued to other taxpayers, and consequently as the IRS issued increasing numbers of PLRs under the Natural Resource Exception, rather than creating general consensus that particular activities generate qualifying income, the IRS appears to have set a market standard

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[36] H.R. Conf. Rep. No. 100-495, at 947 (1987).

[37] *See id.* at 947 (1987), and H.R. Conf. Rep. 100-1104, at 17–18 (1988).

[38] *Id.*

[39] The 1988 Conference Report does not define a ''retail customer'' but excludes ''a person who acquires the oil or gas for refining or processing'' and a utility from the definition of a retail customer. H.R. Conf. Rep. 100-1104, at 17–18.

[40] S. Rep. No. 100-445, at 424 (1988).

[41] §6110(k)(3).

[42] Amy S. Elliott, *PTPs Expand as Fracking, Real Property Rents Generate Qualifying Income*, 2012 TNT 183-2 (Sept. 20, 2012).

[43] The IRS issued eight MLP PLRs in 2007, five in 2008, five in 2009, four in 2010, six in 2011, and 18 in 2012.

[44] *See* Elliott, n. 42 above.

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that a PLR is needed to move forward with the public issuance of an MLP.

Many of the initial PLRs issued to businesses under the Natural Resource Exception were redundant and addressed activities that clearly fell within the scope of §7704(d)(1)(E).[45] However, a few early PLRs began the trend of expanding the scope of the Natural Resource Exception.[46] These early expansive rulings were not controversial, however, as many of them logically flowed from the business realities of the natural resource industry.

3. PLRs Issued Pursuant to the Integral Theory

An early PLR that had one of the greatest impacts in expanding the scope of qualifying income was PLR 9340031, which provided that an activity ''integral to'' a primary qualifying activity produced qualifying income in and of itself.[47] The taxpayer in question owned ''liquid terminaling facilities'' that provided a ''necessary link between two or more forms of product transportation,''[48] making those facilities essential to the transportation of petroleum and related products. The taxpayer, presenting his activities as an ''integral part'' of the transport of oil and gas products thereof, requested that the terminaling fees collected at its facilities be deemed qualifying income.[49] With little analysis, the IRS agreed, allowing the income to qualify as income from ''transportation'' under §7704(d).[50] This PLR marked the first instance in which an activity that was not statutorily enumerated as producing qualifying income, could produce qualifying income if the taxpayer could prove that it was ''integral to'' a separate activity that produced qualifying income under the statute (the ''Integral Theory'').[51]

The Integral Theory has been central to the rapid unofficial expansion in scope of the Natural Resource Exception through the proliferation of PLRs.[52] On its face, the Integral Theory could potentially turn the income from almost any activity that is directed at a third party engaged in a qualifying activity, into qualified income. In reality, the IRS has applied a two-prong test when ruling on Integral Theory grounds.[53] Under the first prong, the activity in question must be ''integral to'' a primary activity that produces qualifying income. The IRS has generally applied a ''significantly curtailed'' standard when making a determination under this prong, asking whether the primary qualifying income producing activity would be ''significantly curtailed'' in the absence of the activity in question.[54] Under the second prong of the Integral Theory test, the activity in question must either (i) generally not have commercial appeal outside of the primary activity it supports, or (ii) if it does have some commercial application, then the activity must enhance the ability of the primary activity to produce qualified income.[55] Despite needing to overcome this two-prong test, businesses were still able to utilize the Integral Theory to continue expanding the definition of qualifying income. In response to this rapid expansion, in the spring of 2014, the IRS began its informal ''pause'' on issuing PLRs under the Natural Resource Exception, in order to take a step back and consider how best to proceed in this area.[56]

4. Fracking and Other Midstream Services

It appears that the MLP Pause was largely motivated by the challenges of ruling on activities associated with midstream services.[57] Before the IRS began the ''pause'' on PLRs issued under the Natural Resource Exception, it issued a number of PLRs that expanded the category of qualifying income, to cover income generated from a large number of midstream sector activities.[58]

The oil industry is commonly categorized into three major sectors: upstream, midstream, and downstream. Companies in the upstream sector are engaged in the first phases of finding and drilling for natural resources; companies in the midstream sector are engaged in the shipping and storage of oil; and companies in the downstream sector refine and distribute natural resources.[59] The midstream sector is the largest of the three, representing 72% of PTPs' total equity market capitalization.[60] Midstream sector companies provide large amounts of infrastructure services: building, owning, and operating pipelines; processing plants; and storage and distribution facilities and ac-

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[45] *See* PLR 9338028 (on whether plywood and fiberboard operations produced qualifying income); PLR 9822034 (on whether engineered wood product operations produced qualifying income); PLR 9932024 (on whether glued wood product operations produced qualifying income).

[46] *See* PLR 9452013 (on whether storage of natural gas produced qualifying income); PLR 9339014 (on whether sale of nitric acid as a byproduct of fertilizer production produced qualifying income).

[47] Todd D. Keator, *'Hydraulically Fracturing' Section 7704(d)(1)(E) — Stimulating Novel Sources of 'Qualifying Income' for MLPs*, 29 Tax Mgmt. Real Est. J. (Bloomberg BNA) 223 (Aug. 7, 2013).

[48] PLR 9340031.

[49] *Id.*

[50] *Id.*

[51] *See* Keator, n. 47 above.

[52] It appears that the IRS may have also relied in part upon the Integral Theory in PLR 9619011; however, the Integral Theory was not used again for more than 10 years. In PLR 200845035, the IRS resurrected this theory to allow income from the construction of pipelines to be treated as qualifying income because such construction was ''integral to'' the company's transportation and gathering activities.

[53] *See* Keator, n. 47 above, at 232.

[54] *Id.* at 232.

[55] *Id.*

[56] *See* n. 3 above.

[57] *See* Elliott, n. 42 above.

[58] *Id.*

[59] *See MLP Basics for Investors*, Nat'l Ass'n of Publ. Traded P'ships, http://www.naptp.org/BasicFacts.html.

[60] *See id.*

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tivities.[61] Because the midstream sector is so large, with a true diversity of activities, and because there is great potential for money to be made through innovation and new lines of business, it is not surprising that businesses in this sector continuously sought to expand the definition of ''qualifying income'' to cover their activities.

One industry that has apparently contributed significantly to the volume of PLRs issued under the Integral Theory is the fracking industry.[62] In general, fracking is the process of extracting natural gas from shale rock layers deep within the earth. Many of the techniques and services used in the process of fracking, especially fluid and water treatment services, are unique to the industry and as such have been fodder for a number of PLRs. PLR 201137005 focused broadly on the transportation of fracking fluids both coming from and going to drill sites, and ruled that income from the supply, transportation, and storage of fracking fluid and other fluids for natural resource wells was qualifying income,[63] while PLR 201222029[64] and PLR 201227002[65] ruled more specifically that the transportation, storage, treatment, and disposal of fracking fluids and byproducts of the process post-drilling, produce qualifying income.

5. The MLP Pause

In March 2014, representatives from the IRS explained that they had ''paused'' their practice of issuing PLRs under §7704.[66] It was reported at the time that the IRS was concerned that some of the PLRs issued may have gone too far.[67] Now that the IRS has lifted the ''MLP Pause,'' it appears that a primary factor motivating the MLP Pause was the IRS's intention to issue broadly applicable guidance in the form of proposed regulations.[68] There are still a number of lingering questions that remain now that the ''MLP Pause'' has been lifted: (1) will the forthcoming proposed regulations bless the previously issued PLRs, and if not, will the IRS revoke any previously issued PLRs that are not blessed by the proposed regulations; (2) will the IRS expand or narrow the scope of §7704(d)(1)(E); and (3) can the IRS draft sufficient bright-line rules to stem the tide of PLR requests?

III. THE REGULATED INVESTMENT COMPANY COMMODITY PLR PAUSE[69]

The IRS[70] faced many of the same issues described above regarding the MLP Pause in dealing with the numerous requests for PLRs involving qualifying income questions for commodity-based investments by RICs,[71] which ultimately culminated in the 2011 RIC Commodity Pause.[72] In contrast to the MLP Pause, the RIC Commodity Pause still persists roughly four years later with no apparent end in sight.[73] As of January 26, 2012, there were at least 28 PLR requests that remained unanswered as a result of the RIC Commodity Pause and, presumably, that number has grown over the last three years.[74] The remainder of this section will highlight some of the issues unique to the RIC Commodity Pause that, ultimately, may be affecting the IRS's ability to lift this pause.

A. Regulated Investment Companies — In General

RICs are generally treated as corporations for federal income tax purposes.[75] Unlike traditional ''C'' corporations, the tax treatment of RICs is significantly modified by subchapter M of the Code, which provides a dividends-paid deduction to RICs, enabling

[61] *Id.*

[62] *See* Elliott, n. 42 above.

[63] The activities contemplated by this PLR include fracking fluid heating services, the treatment and removal of fracking flowback and produced water, and the provision of frack tanks and transportation for fluid removal.

[64] Income from the transportation, storage, and treatment services, and disposal of ''petroleum water-mix'' from the wells was deemed qualifying income.

[65] Income generated from the removal, treatment, recycling, and disposal of fracking flowback, produced water, and drilling muds, contaminated soils, and other residual waste products generated in the fracking process constituted qualifying income.

[66] *See* Elliott, n. 3 above.

[67] *Id.*

[68] *See* Madara, n. 2 above, *and* Rev. Proc. 2015-1, §5.16 (stating that ''[i]n general, the Service will not issue a letter ruling or determination letter on an issue that it cannot readily resolve before the promulgation of a regulation or other published guidance.'').

[69] In the interest of full disclosure, the author served in the IRS Office of Chief Counsel, Financial Institutions and Products until April 2012, and actively worked on many of the RIC commodity PLRs that are referenced in this article. Nonetheless, the following discussion is based upon publicly available information, and any views expressed in this article in no way represent the views of the IRS.

[70] It should be noted that the division of Financial Institutions & Products instituted the RIC Commodity Pause, whereas a separate division, Passthroughs and Special Industries, instituted the MLP Pause. Based on the author's experience, it is highly unlikely that the MLP Pause was coordinated with the RIC Commodity Pause despite the statutory cross-references between §7704 and §851.

[71] The vast majority of RICs are open-end investment companies, commonly referred to as ''mutual funds.'' Closed-end funds (i.e., funds that do not offer to redeem shares daily) and many exchange-traded funds (ETFs) also elect to be taxed as RICs. Note that certain business development companies can also elect to be taxed as RICs.

[72] *See* Sheppard, n. 5 above.

[73] Note that the last Commodity PLR issued to a RIC before the IRS imposed the ''pause'' was issued on May 23, 2011. PLR 201135001 (public release date Sept. 2, 2011).

[74] *Compliance with Tax Limits on Mutual Fund Commodity Speculation: Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. and Governmental Affairs*, 112th Cong., 2d Sess. (2012), http://www.gpo.gov/fdsys/pkg/CHRG-112shrg73671/html/CHRG-112shrg73671.htm.

[75] §851(a).

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them to zero out net income that is annually distributed as dividends to shareholders.[76] The dividends-paid deduction, along with several other provisions of the Code, effectively treat RICs as quasi-passthrough vehicles while preserving their default ''C'' corporation classification.[77]

Among the many rules that modify the treatment for RICs, there are three general limitations that govern the qualification of a corporation as a RIC: it must 1) annually distribute at least 90% of its net income,[78] 2) annually receive at least 90% of its gross income from certain qualifying sources,[79] and 3) quarterly diversify its assets.[80] If a RIC annually satisfies these tests it will avoid an entity-level tax on its income and the RIC's shareholders will in many respects be treated as if they had directly invested in the assets held by the RIC.[81] Any income distributed to the shareholder will only be subject to a single level of tax similar to the taxation for investors in other pass-through entities.

B. The RIC Qualifying Income Test

As mentioned above, a RIC must annually generate at least 90% of its gross income from certain enumerated sources.[82] This requirement is commonly referred to as the ''Qualifying Income Test.''[83] Specifically, §851(b)(2) provides that at least 90% of a RIC's gross income is derived from:

(A) 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 [15 U.S.C. §80a-2], as amended) 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, and

(B) net income derived from an interest in a qualified publicly traded partnership (as defined in subsection (h)).

It is also important to note that §851(b) provides that the character of a RIC's distributive share of partnership income (not derived from a qualifying publicly traded partnership) is treated as if the RIC had earned the income directly.[84] Furthermore, the flush language to §851(b) provides that the income that a RIC receives from a controlled foreign corporation (CFC), to the extent of distributions out of earnings and profits of the CFC, will be treated as a ''dividend'' for purposes of the Qualifying Income Test.[85]

The basic principle for understanding the RIC Qualifying Income Test is that a RIC's income (generally dividends, interest and gains) from direct investments in ''securities,'' as that term is defined in the 1940 Act, or indirectly from its business of investing in such ''securities'' generates qualifying income to a RIC.[86] Because §851(b)(2) enumerates a limited list of qualifying investments, it is generally understood that ''active,'' as opposed to ''passive,'' business activities and non-security-based investments (e.g., commodities) do not generate qualifying income to a RIC.[87]

The IRS reinforced its position, that non-security-based investments do not produce qualifying income to RICs in Rev. Rul. 2006-1.[88] Rev. Rul. 2006-1 held that a total-return swap tied to a commodity index did not generate qualifying income, because the swap was not conclusively a ''security'' and the RIC in question was not deriving income from its business of investing in securities.[89] Rev. Rul. 2006-1 based its authority on the underlying legislative documents that ac-

[76] §852(b)(2)(D).

[77] A RIC is subject to corporate-level tax on any income and gains not distributed to its shareholders. §852(b).

[78] §852(a)(1).

[79] §851(b)(2).

[80] §851(b)(3).

[81] The notable difference between true pass-through entities and RICs is that a RIC cannot pass losses through to its shareholders. *See generally* Johnston, *Taxation of Regulated Investment Companies and Their Shareholders* (WG&L).

[82] §851(b)(2).

[83] Joint Committee on Taxation, *Technical Explanation of H.R. 4337, the "Regulated Investment Company Modernization Act of 2010," for Consideration on the Floor of the House of Representatives*, (JCX-49-10), Sept. 28, 2010.

[84] §851(b) (flush language). However, note that the rule in §851(b)(2)(B) regarding net income derived from a qualified PTP would generally trump this flush language modifier with respect to any PTP (defined in §7704(b) that is classified as a partnership pursuant to §7704(c).

[85] Note that similar rules apply to certain distributions from passive foreign investment companies (PFICs). §851(b) (flush language).

[86] §851(b)(2). Note that a RIC is currently permitted to generate qualifying income from foreign currency (which is considered a commodity under the Code), until such time as the IRS exercises its regulatory authority to exclude such foreign currency gains from net income under §851(b)(2), that are not directly related to a RIC's business of investing in securities. §851(b) (flush language). Note that a RIC may nonetheless be limited by the requirement that at least 50% of its assets be invested in a diversified basket of securities, which likely does not include ''foreign currency.''

[87] *See, e.g.,* 132 Cong. Rec. 4045, 4047–48 (1986) (remarks of Sen. Armstrong, inserting letter of J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy), dated Feb. 5, 1986, to Rep. Flippo). The Mentz letter explained that ''income qualifying under §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 §851(b)(2) should be limited to income from stocks and securities, as opposed to other property.''

[88] Rev. Rul. 2006-1, 2006-1 C.B. 261.

[89] *Id. See also* Stevie Conlon, *Stop! Rev. Rul. 2006-1 Severely Restricts Mutual Fund Investments in Commodity Index Linked Derivatives*, 19 J. Tax'n F. Inst. 4, at 19–26 (2006).

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companied the 1986 expansion and modernization of the Qualifying Income Test, which explained that RICs should be limited to 1) generating income from property held for investment as opposed to property held from sale to customers in the ordinary course of business, and 2) generating income from stock and securities but not from the trading of commodities, even if the commodity hedge is related to a stock investment.[90] Rev. Rul. 2006-1 was modified by Rev. Rul. 2006-31, which stated that Rev. Rul. 2006-1 ''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 §851(b)(2).''[91]

C. The RIC Commodity Pause — The Structured Note and CFC PLRs

In light of the IRS's strong position that it would not bless indirect investments in commodities via a total-return swap, and the lack of clear authoritative guidance, RICs wisely sought the IRS's blessing that indirect investments in commodities produced qualifying income under §851(b)(2). From 2005 to 2011, the IRS was flooded with PLR requests involving commodity-related investments for RICs, and the IRS issued 72 PLRs[92] before instituting a self-imposed ''pause'' in issuing commodity-related PLRs to RICs.[93] The 72 PLRs generally asked one or both of the following questions: 1) whether investments in certain commodity-linked structured notes produced qualifying income (the Structured Note Rulings), or 2) whether dividends derived from the stock investment in a subsidiary CFC or PFIC that invested directly in commodities and commodity-linked derivatives produced qualifying income (the CFC Rulings).[94]

The Structured Note Rulings involved highly customized leveraged notes tied to the performance of a commodity index, which contained a knockout provision to protect principal if the value of the commodity index dropped too precipitously. The Structured Note Rulings do not provide a rationale for holding that the income produced from the structured note is qualifying income pursuant to §851(b)(2). Nonetheless, multiple commentators have noted that it appears that the IRS based its holding on the fact that the structured notes would be a hybrid ''security'' within the jurisdiction of the Securities and Exchange Commission (SEC) and accordingly a ''security'' under the 1940 Act.[95]

The CFC PLRs involved income derived from a RIC's investment in its wholly owned Cayman Islands subsidiary, which would be taxed as a CFC under §957. Ultimately, the holdings of the CFC PLRs provide that subpart F income to a RIC parent is qualifying income, even where the CFC subsidiary has directly invested in commodities and other commodity derivatives. The highly technical answer provided by the CFC PLRs, is that a RIC does not need to receive a distribution from its commodity CFC subsidiary in order to treat subpart F income from the CFC as qualifying income under §851(b)(2).[96]

The CFC Rulings served two practical purposes in addition to answering the technical question: 1) some practitioners believed that the IRS was implicitly blessing the blocker structure used by RICs to cleanse ''bad'' commodity income and transform it into ''good income,'' because the IRS generally does not issue PLRs wearing blinders (i.e., ruling on one issue while ignoring other problematic steps/issues in the transaction);[97] and 2) the CFC Rulings eliminated the ministerial requirement that a CFC distribute cash to its parent RIC to generate qualifying income, which would be reinvested back into the CFC in most cases.

When the IRS first ''paused'' their ruling practice, it was thought to be a temporary halt, instituted in order to ''rethink the rulings.''[98] Months after the ''pause'' was initiated the IRS was still sending strong public signals that it intended to issue public guidance that would resolve the backlog of RIC PLR requests and level the playing field between the RICs that had received a ruling and those that had not.[99] However, the fate of the RIC Commodity Pause may have been sealed when Congress took an interest in the RIC PLRs, convening a Congressional hearing in which the Commissioner of the IRS was called upon to defend the IRS's position on the 72 RIC Commodity PLRs that had been issued.[100]

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[90] *See* 132 Cong. Rec., n. 87 above. The IRS has cited this background legislative history at least five times subsequent to the issuance of Rev. Rul. 2006-1. *See, e.g.,* PLR 201103036; PLR 201106006; PLR 201319003; PLR 201406007; and PLR 201425009.

[91] Rev. Rul. 2006-31, 2006-1 C.B. 1133.

[92] *See* n. 70 above.

[93] *See* Sheppard, n. 5 above.

[94] *Id.*

[95] The nuances of the commodity-linked structured note PLRs is beyond the scope of this article. For a detailed examination see James R. Brown, *Commodity-Linked Instruments and the Proper Scope of Mutual Fund Taxation*, 2006 TNT 152-81 (Aug. 8, 2006).

[96] The technical issues surrounding the CFC rulings are well beyond the scope of this article, however, for a detailed explanation of the issues, see Dale S. Collinson, *Qualifying Income of a RIC From Investment in a CFC*, 2007 TNT 30-49 (Feb. 13, 2007).

[97] *See, e.g.,* David H. Shapiro and Jeffrey W. Maddrey, *IRS Implicitly Rules on Economic Substance Doctrine and Blockers* (Mar. 22, 2011); *see also* Rev. Proc. 2015-1, §6.02 (stating that ''the Service may decline to issue a letter ruling or a determination letter when appropriate in the interest of sound tax administration, including due to resource constraints'').

[98] *See* Sheppard, n. 5 above.

[99] Lee A. Sheppard, *IRS Will Allow Mutual Fund Commodities Investments*, 2011 TNT 207-1 (Oct. 26, 2011).

[100] *See* n. 70 above.

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IV. SECTIONS 7704 AND 851 — OBSERVATIONS ON PASSIVE INCOME

A. Parallels Between the MLP and RIC Commodity Pauses

At first glance the MLP Pause and the RIC Commodity Pause may not seem to have much in common. The MLP Pause is ostensibly concerned with the IRS's reevaluation of how closely linked an ancillary activity needs to be a statutorily enumerated activity to generate qualifying income under the Natural Resource Exception. The MLP Pause had no effect on direct income and gain from oil and natural gas activities because §7704(d)(1)(E) unambiguously provides that such activities produce ''passive'' qualifying income.[101] In contrast, the RIC Commodity Pause involves the question of how closely (if at all) a nonsecurity investment (commodity derivative) or an indirect commodity investment in a subsidiary needs to be tied to a RIC's primary business of investing in securities to generate qualifying income.[102] Notwithstanding the IRS's treatment of MLPs, it does not appear that the IRS will resume blessing PLR requests from RICs which permit a RIC to generate qualifying income from commodity investments unless the RIC obtains that commodity exposure via investment in a PTP or MLP.

Both pauses demonstrate the challenges that taxpayers and the IRS face in reconciling statutory provisions that do not directly involve core tax policy considerations.[103] Both pauses also demonstrate that when the IRS is overloaded with PLR requests, it sends a strong signal that the IRS needs to reevaluate its practice. For example, it should not be necessary for the IRS to issue repetitive PLRs to numerous taxpayers; rather the IRS should be able to issue broadly applicable guidance that all taxpayers can rely upon. If the IRS cannot easily issue broadly applicable guidance, this may suggest that the underlying PLRs are not clearly articulating the underlying legal theories that support their holdings.

B. Sources of Passive Income

It is also clear from the legislative history that similar tax policy considerations affected Congress's decisions to enable MLPs, and RICs, to avoid corporate level tax from passive income sources; in the case of RICs, income from securities, and in the case of MLPs, income from natural resources (and other passive income sources for PTPs in general). Specifically, regarding RICs, Congress believed that a single level of tax should be afforded to trusts that simply reinvested and managed the investments of others (i.e., putting RIC shareholders in the same tax position as if they had directly invested their capital).[104] With regard to MLPs, Congress sought to prevent businesses from ''erod[ing] . . . the corporate base'' by converting to partnership form while subjecting passive income to a single level of tax.[105] The administrative challenges that ultimately led to the MLP Pause, and the RIC Commodity Pause also appear to have resulted, at least in part, from the IRS's attempts to reconcile mixed messages from Congress regarding the scope of ''passive income.''

1. Passive Income of MLPs

As explained above, Congress created the Natural Resource Exception, permitting income from active natural resource operations to qualify for passthrough treatment, while concurrently explaining that the primary purpose behind the PTP regime was to ensure that active business operations were subject to corporate-level tax.

On the one hand, the legislative documents underlying the enactment of §7704 explain that:

> [t]he suggestion is that natural resource activities, which have traditionally been held in partnership form and have been sort of passive investments that partners have been buying into for many years, that the single tax regime be preserved like it is for real estate investors who invest in real estate investment trust, like it is for investors in a mutual fund. It is the ability of investors to access a particular kind of asset, usually a wasting asset or an income-producing asset, that is not actively managed.[106]

The following is an example of more complex statements in the legislative documents regarding the scope of the Natural Resource Exception:

> Oil, gas, or products thereof are not intended to encompass oil or gas products that are

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[101] Note that such income would be considered nonqualifying commodity-based income if a RIC directly held an investment in a partnership that did not qualify under §7704 as a partnership. Note, however, §7704(d)(1)(F) would be the more traditional avenue for classifying income and gain from trading in commodities as qualifying income.

[102] It should be noted, that two of the first three CFC PLRs were actually issued under §7704(d)(1). *See* PLR 200728025 and PLR 200722007.

[103] ''Timing, character, and source'' are generally understood to be central principles to U.S. federal income taxation. *See, e.g.,* Staff on the Joint Comm. on Tax'n, *Present Law and Issues Related to the Taxation of Financial Instruments and Products* (JCX-56-11) at 14 (Dec. 2, 2011). It would appear that an analysis of the nuances of the operations of natural resource-related companies and the determination of whether a commodity derivative is a security are not traditional questions answered by core tax principles.

[104] Revenue Act of 1936, Pub. L. No. 74-740, 49 Stat. 1648 (''1936 Act''); Statement of Paul C. Cabot and Merrill Griswold representing State Street Investment Corporation, Boston, Massachusetts before the Senate Finance Committee in June 1936.

[105] *Hearings Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means*, House of Representatives, H.R. Hrg. 100-39, 100th Cong. 8–9 (June 30, 1987) (statement of Roger Mentz, Treasury's Assistant Secretary for Tax Policy).

[106] *See id.* at 34.

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produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives. *Income of certain partnerships whose exclusive activities are transportation and marketing activities is not treated as passive-type income*. For example, the *income of a partnership whose exclusive activity is transporting refined petroleum products by pipeline is intended to be treated as passive-type income, but the income of a partnership whose exclusive activities are transporting refined petroleum products by truck, or retail marketing* with respect to refined petroleum products (e.g., gas station operations) *is not intended to be treated as passive type income*.[107]

The legislative materials accompanying the technical correction to §7704 also provide as follows:

> With respect to marketing of minerals and natural resources (e.g., oil and gas and products thereof), the *Committee intends that qualifying income be income from marketing at the level of exploration, development, processing or refining oil and gas. By contrast, income from marketing minerals and natural resources to end users at the retail level is not intended to be qualifying income*. For example, income from retail marketing with respect to refined petroleum products (e.g., gas station operations) is not intended to be treated as qualifying income.[108]

While this legislative history clearly indicates that active business operations will produce qualifying income depending on how close the activity is to the development of the natural resource, it nonetheless creates a standard that does not naturally fit within the realm of tax laws. This ambiguous standard forces IRS tax lawyers to effectively become engineers, administering the tax law without an overarching tax policy to guide them (e.g., no clear line between active/passive business operations).[109]

2. Passive [Commodity] Income of RICs

Congress appears to have sent similarly mixed messages to the IRS when reforming the RIC Qualifying Income Test. On the one hand, there has been a consistent message for the past 80 years that the RIC rules were designed for passive investment sources.[110] On the other hand, certain statements regarding the 1986 expansion of the sources of qualifying income offer inconsistent messages regarding whether all passive income sources produce qualifying income to a RIC. The 1986 amendments to §851 were introduced as legislation to ''modernize,'' and to ''afford mutual fund managers the opportunity to make investment decisions that accommodate today's marketplace.''[111] Just as confounding, is the following statement associated with the 1986 revisions to the RIC qualifying income test, which was relied upon by the IRS in Rev. Rul. 2006-1 to narrow the scope of qualifying income for RICs:

> 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 . . . 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.[112]

The 1986 conundrum can be simplified as follows: RICs are meant to be passive investment vehicles that can take advantage of modern investment techniques; however, those modern investment techniques do not include passive buying and selling commodities [derivatives], even when such passive buying and selling is directly related to a RIC's passive business of investing in securities. Query how buying and selling commodities by a PTP generates passive income, whereas buying and selling commodities (and commodity derivatives) does not generate passive income to RICs even when directly related to the RIC's core business of investing in securities.

The message regarding whether a RIC's investment in commodity-related investments produces qualifying income was further muddied in 2004 when Congress modified §851(b) to provide that a RIC's net income from a PTP produces qualifying income.[113] Prior to this 2004 modification, a RIC needed to look through all partnerships (including PTPs qualifying under §7704) to determine whether the RIC's income from each partnership qualified under §851(b)(2). Therefore, before 2004, if a RIC invested in a PTP that generated qualifying income under §7704(d)(1)(E) (natural resources) or §7704(d)(1)(F) (commodity pools), such income in the hands of the

[107] H.R. Rep. No. 495, 100th Cong., 1st Sess. 943 (1987), 1987-3 C.B. 226–227 (emphasis added).

[108] S. Rep. No. 445, 100th Cong., 2d Sess. 424 (1988) (emphasis added).

[109] *See* Madara, n. 2 above. An IRS lawyer is quoted as saying ''we've spent significant time studying the issues [and] we have worked extensively with engineers in [the Large Business and International Division] to develop workable standards to guide our ruling practice.''

[110] *See* n. 99 above (written Statement by Dennis E. Ross, Tax Legislative Counsel, Department of the Treasury).

[111] N. 81 above (testimony of Sen. Armstrong).

[112] 132 Cong. Rec. 4045, 4047–8 (1986) (remarks of Sen. Armstrong, inserting letter of J. Roger Mentz, Acting Assistant Secretary of the Treasury (Tax Policy), dated Feb. 5, 1986, to Rep. Flippo).

[113] H.R. Rept. No. 108-548, 108th Cong., 2d Sess., pp. 151–153 (2004).

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RIC limited partner would not be considered qualifying income under §851 (i.e., active business income from natural resource operations or income from commodities). In explaining the significant broadening of the qualifying income sources for RICs, Congress provided two caveats, neither of which had anything to do with whether commodity-based income properly constitutes qualifying income to a RIC:

> [t]he Committee believes that permitting mutual funds to hold interests in a publicly traded partnership should not give rise to avoidance of unrelated business income tax or withholding of income tax that would apply if tax-exempt organizations or foreign persons held publicly traded partnership interests directly rather than through a mutual fund.[114]

As explained above, the limits on a RIC's receipt of qualifying income from PTPs had little to do with the underlying character of the sources (e.g., commodities and natural resources), as Congress generally understood that such sources "are commonly considered to be passive investments."[115] Rather, these limits on qualifying income from PTPs were imposed because Congress was mainly concerned with income and gains from PTPs that were completely escaping taxation through the use of a RIC as a blocker.[116] Accordingly, as a compromise to Congress's concern for PTPs using RICs as blockers, Congress limited a RIC's holdings in PTPs to 25% of the RIC's assets and provided that qualifying income will be limited to income from qualifying PTPs (QPTPs). A QPTP is a PTP that qualifies for taxation as a partnership without generating the same type of qualifying income as a RIC.[117]

The issue of whether RICs should be permitted to invest in commodities was further complicated by the 2010 proposed House amendment to §851, which would have permitted RICs to make unrestricted commodity investments. Apparently, at the last second, the Senate stripped the commodity provision — its only amendment to the House-passed bill. As subsequently summarized by Senator Carl Levin, "[s]o the short story is that Congress did not agree to adding commodities to the list of acceptable income for mutual funds under the 90-percent rule."[118]

Despite the legislative parallels between the MLP Pause and the RIC Commodity Pause, the significant difference that likely explains why the MLP Pause has now been lifted while the RIC Commodity Pause continues, is that certain members of Congress directly weighed in on the RIC Commodity Pause. Specifically, these members challenged the IRS's issuance of the 72 RIC Commodity PLRs, requested that the "RIC Commodity Pause" be turned into a "moratorium," and held a Congressional hearing on the issue.[119] Furthermore, the RIC Commodity Pause involves a definitional cross-reference to the term "security" under the 1940 Act, which introduces additional jurisdictional complexities to the equation.[120] Now that it has been almost three years since the IRS last publicly discussed the RIC Commodity Pause, it appears that the RIC Commodity Pause has transformed into a "moratorium," solidifying the unlevel playing field (at least as a matter of IRS ruling availability) that the IRS originally sought to avoid.[121]

C. The Statutory Cross-References to §851 and §7704

The question that still remains unanswered is whether the statutory cross-references between §851(b)(1) and §7704(d)(4) (i.e., a PTP can generate passive qualifying income from an investment in a RIC and a RIC can generate passive qualifying income from an investment in a PTP) should ultimately influence the IRS's interpretation of "passive income" issues in the future. It would seem logical that passive income which is only subject to one level of tax should be given similar meanings under Code sections that reference one another when determining "passive income." For example, it seems entirely illogical that a RIC can generate passive qualifying income from a PTP, while simultaneously generating nonqualifying income from direct investments in the same sources that generate passive income for a PTP. Unless there is another regulatory rationale[122] that provides a logical basis for distinguishing between "passive commodity derivative income" for RICs and PTPs, it seems that the two statutory provisions should be read as compatible provisions.

V. STRUCTURING CONSIDERATIONS FOR AN MLP-FOCUSED RIC

A. The Benefits of Investing in MLPs

MLPs are popular investments today because they produce significant and reliable cash distributions.

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[114] *Id.* at 154.

[115] *See generally id.*

[116] See V.C., below, for a more detailed explanation. A RIC generates dividends and capital gains, which to a tax-exempt investor would not be subject to taxation. *See* §512(b).

[117] §851(h).

[118] *See* n. 99 above.

[119] *See, e.g.,* Meg Shreve, *Levin to Call for Extension of Moratorium on Mutual Fund Letter Rulings*, 2012 TNT 17-4 (Jan. 26, 2012); *see also Levin, Coburn Call on IRS to Stop Issuing Mutual Fund Letter Rulings*, 2012 TNT 17-31 (Dec. 20, 2011).

[120] *Id.*

[121] Joseph DiSciullo, *ABA Meeting: IRS Speakers Track Progress of RIC Guidance Projects*, 2012 TNT 93-21 (May 14, 2012).

[122] Note, that §8(b) of the 1940 Act does not directly restrict an investment company's ability to invest in commodities, but does require that every investment company disclose in its registration statement the extent to which it intends to invest in commodities. 15 U.S.C. §80a-8(b).

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MLPs are also advantageous to investors because of certain accelerated depreciation deductions for which they are eligible.[123] These depreciation deductions shelter what would otherwise constitute allocations of current taxable income to investors. The result is that considerable portions of MLP distributions are received by investors as non-taxable returns on their capital investment rather than as income subject to current taxation. However, this return of capital reduces the tax basis on the investment in the MLP, and any gain arising from the eventual sale of MLP interests is measured by the difference between the reduced tax basis and the sales proceeds.[124] The result is that tax on the return of capital distributions is, in essence, deferred until the disposition of an MLP interest. Note that if any deferred gain is recognized at the time of the disposition of MLP interests, it is generally taxable at capital gain rates[125] (although a portion of such gain may be taxable as ordinary income because it represents a recapture of depreciation and/or includes other unrealized receivables or inventory items of the MLP).[126]

B. Qualifying Income from MLPs and PTPs — In General

For the reasons highlighted above, MLP investments are currently very attractive to many types of investors, including RICs. RICs also invest in MLPs because such investments are thought to diversify a RIC's traditional equity and bond portfolios; it is understood that MLPs are not strongly correlated with the broader equity and bond markets.[127] As explained above, however, RICs are generally limited to investing in securities (e.g., stocks and bonds).[128] Therefore, the challenge for RICs seeking exposure to MLPs and the broader commodities markets, is that MLPs and commodity pools are generally formed as partnerships that do not issue "securities" for purposes of the RIC Qualifying Income Test.[129] As mentioned above, the flush language to §851(b) generally requires a RIC to look through a partnership interest to determine the character of the underlying income generated from that interest.

MLP common units and other limited partnership interests from commodity pools would clearly generate non-qualifying income to a RIC limited partner if the RIC had to look through the partnership interest; however, as also explained above, RICs can now receive qualifying income from such entities through the application of §851(b)(2)(B), which generally provides that the net income from a "qualified publicly traded partnership"[130] is qualifying income to a RIC. Accordingly, the RIC Qualifying Income Test is no longer the main challenge for RICs investing in MLPs and other PTPs. Rather, it is the limitation in §851(b)(3)(B)(iii) that restricts a RIC to investing no more than 25% of the value of its assets in the securities of one or more PTPs at the close of each quarter of its taxable year.[131]

C. The 25% Limit for RICs Investing in MLPs and PTPs

In enacting §851(b)(2)(B) (qualifying income) and §851(b)(3)(B)(iii) (asset diversification limit), Congress explained that:

> The Committee understands that these types of publicly traded partnerships may have improved access to capital markets if their interests were permitted investments of mutual funds. Therefore, the bill treats publicly traded partnership interests as permitted investments for mutual funds ("RICs"). Nevertheless, the Committee believes that permitting mutual funds to hold interests in a publicly traded partnership should not give rise to avoidance of unrelated business income tax or withholding of income tax that would apply if tax-exempt organizations or foreign persons held publicly traded partnership interests directly rather than through a mutual fund. Therefore, the Committee bill requires that present-law limitations on ownership and composition of assets of mutual funds apply to any investment in a publicly

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[123] *See generally* http://www.naptp.org/PTP101/Print/Basic_Tax_Principles.pdf.

[124] *Id.*

[125] *Id.*

[126] *Id.*

[127] Kevin Mahn, *What You Need to Know About MLPs and Investing in Energy*, Forbes.com (Aug. 10, 2012), (http://seekingalpha.com/article/219768-mlps-part-3-correlation-between-stocks-bonds-and-mlps).

[128] §851(b).

[129] Note, although MLP common units fall within the definition of "securities" for purposes of the Securities Act of 1933 and the 1940 Act, for U.S. federal income tax purposes, the fact that the common units are limited partnership interests trumps the "security" classification under the federal security laws. For a detailed discussion on this point, see Johnston, *Taxation of Regulated Investment Companies and Their Shareholders* (WG&L), n. 322.

[130] A "qualified publicly traded partnership" is defined in §851(h) to mean a PTP under §7704(b) "other than a partnership which would satisfy the gross income requirements of §7704(c)(2) if qualifying income included only income described in subsection (b)(2)(A) [of §851]."

[131] It should also be noted that in addition to the 25% limit, RICs have to meet a separate diversification test. Section 851(b)(3)(A) provides that at least 50% of RIC's total assets at the close of each quarter must be represented by cash, government securities, other RICs and other securities "in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of the [RIC] and to not more than 10% of the outstanding voting securities of such issuer." Note that §851(c)(5) includes PTP securities within the definition of an "issuer" for purposes of §851(b)(3) which effectively means that a RIC also has to determine whether a particular PTP issuer can be included in its 50% basket.

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traded partnership by a mutual fund. The Committee believes that these limitations will serve to limit the use of mutual funds as conduits for avoidance of unrelated business income tax or withholding rules that would otherwise apply with respect PTP income.[132]

The above legislative language clearly explains that because MLPs and other PTPs generate passive income, they are appropriate investments for RICs. In addition, the expansion of the RIC qualifying income test was intended to encourage investment into the MLP industry. However, the 25% limit on investing in MLPs had little to do with whether the income generated by such investments was passive enough under the Qualifying Income Test. Rather, Congress was concerned that RICs could be used by tax-exempt entities seeking to avoid unrelated business taxable income (UBTI), and by non-U.S. persons seeking to avoid effectively connected income (ECI) from direct investments in PTPs.[133]

D. RICs as Blockers for UBTI and ECI

Congressional drafters correctly noted that because RICs are corporations under the Code, a RIC generally blocks any UBTI or ECI from being passed along to its shareholders when the RIC makes dividend and capital gains distributions.[134] In other words, a RIC's distributions, of dividends and capital gains to shareholders, do not generally carry a UBTI or ECI taint.[135] Accordingly, ''passive income'' from MLPs could flow through a RIC to a tax-exempt entity or non-U.S. person, and such income could potentially escape taxation.[136] In the author's experience tax-exempt entities and non-U.S. entities rarely make large investments in RICs as a means of obtaining exposure to MLPs, because there are alternative structures that provide better exposure to MLPs that often produce similar tax results.[137] Accordingly, it appears that the 25% limit on a RIC's investment in MLPs simply makes it more difficult for retail investors to achieve exposure to MLPs and the broader commodities industries.

[132] *See* n. 107 above, at 152.

[133] *Id.* at 152–153.

[134] *Id.* Note the discussion of whether income and gain from an MLP is ECI is beyond the scope of this article. However, for purposes of this article, it is assumed that a least a portion of any gain from the sale of an MLP limited interest would be ECI and subject to withholding on distributions to non-U.S. persons under Reg. §1.1446-4.

[135] Note, there are instances in which UBTI and ECI may flow through to a RIC's shareholders.

[136] §512(b)(1), §512(b)(5), §871(a)(2).

[137] For example, see the discussion of C-Corp MLP Funds below.

E. Structuring Considerations for RICs Seeking Greater Exposure to MLPs

Although certain RICs may market themselves as MLP funds, the 25% asset limit severely challenges the ability of RICs to gain full market exposure to MLPs. MLP RICs may attempt to gain additional exposure to MLPs by investing in other MLP funds taxed as C corporations, by investing in leveraged derivatives tied to an MLP index, or by investing in other RICs. Note, however, that each of these alternative options has significant drawbacks (as discussed below).

i. MLP C Corporation Funds and I-Shares

One of the ways that a RIC can achieve additional exposure to MLPs is through investing in an MLP fund that is organized as a traditional ''C'' corporation (a C-Corp MLP Fund), but which invests in multiple MLPs. Similarly, a RIC can invest in ''I shares,'' which are an indirect investment in one particular MLP, issued by the MLP's corporate affiliate. Because C-Corp MLP Funds and I-Shares[138] are not PTP interests, a RIC does not count its investment in those securities against its 25% limit on investing in PTPs/MLPs.

Unlike a RIC, a C-Corp MLP Fund can invest 100% of its portfolio in MLPs.[139] A potential drawback to a C-Corp MLP fund is that any income that it recognizes may be subject to a corporate-level tax before distributions are made to shareholders as dividends.[140] Note, however, that because most MLPs have significant amounts of depreciable assets, a large portion of the distributions received by a C-Corp MLP Fund from its MLP investments will be a return of capital, rather than income or gain subject to current corporate-level tax. Accordingly, if a C-Corp MLP Fund in turn distributes the cash distributions it received as a return of capital, the C-Corp MLP Fund shareholders will also likely receive distributions that are characterized as a return of capital. These returns of capital distributions would be nontaxable to the extent of a shareholder's basis in the C-Corp MLP Fund, and capital gain rates would apply thereafter. One of the other main advantages to an investment in a C-Corp MLP Fund is that these funds are effectively designed to be K-1 aggregators. MLPs tend to issue K-1s from all the states in which they operate. The C-Corp MLP Fund receives the K-1s and issues a single Form 1099 to its investors, which is a big draw, in particular for those who are tax-exempt. Similarly, non-U.S. investors are drawn to C-Corp MLP Funds

[138] The remainder of this section focuses solely on C-Corp MLP Funds; however, much of the analysis applies to I-Shares also.

[139] http://www.forbes.com/sites/advisor/2014/09/30/what-you-need-to-know-about-mlps-and-investing-in-energy/.

[140] *Id.*

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because these investments generally do not produce a filing requirement in the United States.[141]

The drawback, however, for a RIC that invests in a C-Corp MLP Fund is that the RIC's investment will be subject to advisory/management fees by the C-Corp MLP Fund. RICs could avoid these fees if they were permitted to invest directly in the MLPs in the portfolio of the C-Corp MLP Fund. In addition, a RIC's return from its investment in a C-Corp MLP Fund is negatively affected if the C-Corp MLP Fund begins receiving allocations of taxable income from the MLPs without an offsetting deduction; in that case the C-Corp MLP Fund would be subject to federal, state, and local income tax on such taxable income.

It should be noted that in certain cases, C-Corp MLP Funds represent desirable investment opportunities for tax-exempt investors and non-U.S. persons. For a tax-exempt investor, the return of capital distributions from a C-Corp MLP Fund would not carry a UBTI taint. Furthermore, because return of capital distributions would reduce the tax-exempt investor's basis in the C-Corp MLP Fund, the tax-exempt investor would likely recognize capital gain from the eventual sale of its interest in the C-Corp MLP Fund that would also be excluded from the definition of UBTI.[142] Note, however, that the net asset value (NAV) of the C-Corp MLP Fund would be affected by calculations of deferred tax liabilities associated with unrealized appreciation (or depreciation) from the fund's investments in MLPs. This deferred tax liability would ultimately affect a shareholder's return (including that of a tax-exempt investor) from an investment in a C-Corp MLP Fund. Furthermore, a review of tax disclosures for C-Corp MLP Funds reveals that these funds typically take the position that non-U.S. investors will not be subject to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) on the sale of their stock.[143]

ii. Investments via an MLP Index Derivative and via Other RICs

RICs seeking MLP exposure have at least two additional options; to invest in a derivative tied to an MLP index, or to invest in another MLP-focused RIC. While MLP index derivatives may provide greater exposure to MLPs, it is not entirely clear how a RIC would account for such derivatives under the RIC asset diversification rules of §851(b)(3) and whether investment in these derivatives is affected by the 25% limit on investment in PTPs under §851(b)(3)(B)(iii).[144] The clear drawback to investing in other MLP-focused RICs is that the other MLP-focused RICs are also limited to investing 25% of their assets in MLPs.[145]

VI. CONCLUSION

As MLPs continue to be attractive investments for the broader investing public there will be increasing pressure for RICs to gain exposure to this asset class and to the broader commodities markets. The question that remains is whether commodities limitations and the 25% limit investments in MLPs will persist in light of this pressure. It appears that the final chapters on the MLP Pause and the RIC Commodity Pause have yet to be written.

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141 §6012 (flush language), assuming that any income from a C-Corp MLP Fund is properly withheld upon at the source.

142 §512(b)(5).

143 Whether a C-Corp MLP Fund will be treated as a U.S. Real Property Holding Company, subjecting its non-U.S. investors to FIRPTA, is a fact-sensitive inquiry and beyond the scope of this article.

144 For a more complete discussion, see Amy B. Snyder, *Regulated Investment Companies and Commodity-Linked Instruments: The Current State of Play*, 10 J. Tax'n F. Inst. 3 (2012).

145 It should also be noted that the IRS has recently issued proposed regulations, which if finalized without modification, would require RIC 1 to look through any investment in RIC 2 if RIC 1 controls 20% of the stock of RIC 2. In such a case, RIC 1 would need to determine whether it satisfies the asset diversification test of §851(b)(3) by also attributing an applicable percentage of RIC 2's assets to RIC 1. This rule could potentially trip up a RIC seeking to gain additional exposure to MLPs via investing in other RICs or other corporations. For a discussion of these proposed regulations, see Amy S. Elliott and Lee A. Sheppard, *Treasury Issues Proposed Regs Clarifying RIC Controlled Group Rules*, 2013 TNT 149-6 (Aug. 2, 2013) (discussing REG-114122-12, 2013-35 I.R.B. 163, 78 Fed. Reg. 46851 (Aug. 2, 2013)).

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