Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:FIP:B02 – PLR-116778-03
Date:
May 17, 2004

In Re:

Legend

Fund 1 =

Fund 2 =

Fund 3 =

Fund 4 =

Company 1 =

Company 2 =

Company 3 =

State 1 =

State 2 =

Dear :

This responds to your request for a ruling dated March 4, 2003, and supplemental correspondence dated October 21, 2003, January 16, 2004, February 17, 2004, and March 4, 2004, submitted on behalf of Funds. Funds request a ruling that gains from options on gold and futures contracts on gold that are entered into to reduce the risks of holding long positions in gold-related securities constitute other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in stock, securities, or currencies within the meaning of section 851(b)(2) of the Internal Revenue Code of 1986, as amended ("Code").

FACTS

Fund 1 and Companies 1-3 are registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the 1940 Act), as diversified, open-end management companies. Fund 1 and Companies 1 and 2 are organized as corporations under the laws of State 1; Company 3 is organized as a business trust under the laws of State 2. Fund 2 is a segregated portfolio of assets ("series") of Company 1, Fund 3 is a series of Company 2, and Fund 4 is a series of Company 3, and each such Fund is a "fund" as defined in § 851(g)(2) and, accordingly, is treated as a separate corporation for federal tax purposes pursuant to § 851(g)(1). Each Fund has fulfilled all the requirements to be treated as a regulated investment company (RIC) under subchapter M, part I, of the Code for its most recent taxable year.

Funds allocate their assets among domestic and foreign stocks, bonds, and short-term instruments. Funds invest in the stock and securities of issuers engaged in the businesses of mining, processing, producing, exploring for, refining, and selling gold ("gold-related securities"). Funds may also invest directly in gold and other precious metals. Funds are also authorized to invest in options and futures contracts if they are authorized to invest in the type of asset by which the return on, or value of, the option or futures contract is measured.

Funds wish to protect themselves against adverse movements in the price of gold-related securities. Issuers of gold-related securities generally are small market capitalization companies, many of which are thinly traded. Put or call options on these securities are limited in availability and do not provide an adequate offset to Funds' level of risk because of the size of Funds' positions in gold-related securities. In order to reduce or hedge the level of risk in their investment in gold-related securities, they may invest in options on gold and futures contracts on gold.

A Fund assesses market factors in determining a need to reduce or hedge the level of risk of a decline in the value of a particular gold-related security. It selects an option on gold or futures contract on gold as an economic hedge to that security based on its examination of (1) the correlation between price movement in the gold-related security and the potential hedge; (2) the cost of the potential hedge; (3) the liquidity of the potential hedge; (4) the relative values of the gold-related security and the potential hedge; and (5) other factors affecting the price of the potential hedge. Funds represent that there has been a historical correlation over the past 20 years between the price of gold bullion and the value of stock in gold mining companies, as reflected in the Philadelphia Gold & Silver Index (XAU).

A Fund identifies and records the selection and purchase of an option on gold or futures contract on gold as an economic hedge on a gold-related security by designating the option on gold or futures contract on gold as a hedging instrument with respect to a particular gold-related security in an internal electronic mail message sent on the day the option on gold or futures contract on gold is purchased. A hard copy of this electronic message is retained in a physical file (containing other information such as trade tickets and broker confirmations) established for the option on gold or futures contract on gold. Designation of the hedging transaction will also appear on an internal quarterly report generated to record all information pertinent to all trades in options and futures contracts.

LAW AND ANALYSIS

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

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

Section 851 (b)(2) provides that, to qualify as a RIC, at least 90 percent of its gross income must be derived from dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies.

Section 1.246-5(b)(1) of the Income Tax Regulations (the regulations) provides that the term “substantially similar or related property” is applied according to the facts and circumstances in each case. In general, property is substantially similar or related to stock when --

(i) The fair market values of the stock and the property primarily reflect the performance of --

(A) A single firm or enterprise;

(B) The same industry or industries; or

(C) The same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and

(ii) Changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property.

Section 1.246-5(b)(2) of the regulations provides that a taxpayer has diminished its risk of loss on its stock by holding positions with respect to substantially similar or related property if changes in the fair market values of the stock and the positions are reasonably expected to vary inversely.

Section 1092(a)(2)(B)(i) provides that the term "identified straddle" means any straddle--

(i) which is clearly identified on the taxpayer's records as an identified straddle before the earlier of--

(I) the close of the day on which the straddle is acquired, or

(II) such time as the Secretary may prescribe by regulations.

Authorities under sections 246 and 1092 are not controlling for purposes of section 851(b)(2), but may provide useful guidance in interpreting substantially similar concepts arising under section 851(b)(2). Section 1.246-5 of the regulations provides definitions of the terms “substantially similar or related property” and “diminished risk of loss” for purposes of the determination of the holding period applicable to stock whose dividends may qualify for the dividends received deduction. Section 1092 provides rules relating to straddles, including rules on how and when a straddle is identified.

Funds represent that they will invest in options on gold and futures contracts on gold in order to reduce or hedge the level of risk in their investment in gold-related securities and will identify each option or futures contract as a hedging instrument with respect to a particular gold-related security in the manner described in this letter. To the extent that, with respect to a particular gold-related security, an option on gold or a futures contract on gold—

(1) consists of substantially similar or related property within the meaning of §1.246-5(b)(1) of the regulations;

(2) is entered into to diminish the risk of loss, within the meaning of §1.246-5 (b)(2) of the regulations, on a Fund’s investment; and

(3) is clearly identified on a Fund’s records as a hedging instrument with respect to that security, using appropriately modified versions of the definitional rules of section 1092(a)(2)(B)(i), relating to the time and method by which a straddle is identified,

we rule that gains derived from such options on gold and futures contracts on gold constitute other income derived with respect to a Fund's business of investing in stock, securities or currencies within the meaning of § 851(b)(2) of the Code.

No opinion is expressed or implied concerning the federal income tax consequences of the transaction described in this letter, except as expressly provided. In particular, no opinion is expressed or implied with respect to the tax treatment of options on gold and futures contracts on gold under sections 246, 263(g), 1092, or 1256, and no opinion is expressed or implied as to whether the method of identification would be sufficient for purposes of § 1.1092(b)-3T(d).

This ruling is directed only to the taxpayers who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file, we are sending a copy of this letter to the taxpayer.

A copy of this letter should be attached to the federal income tax return of a Fund for each taxable year in which it recognizes gains from options on gold and futures contracts on gold under the circumstances described in this letter.

Sincerely,

Susan Thompson Baker
Susan Thompson Baker
Assistant to the Branch Chief, Branch 2
Office of Associate Chief Counsel

(Financial Institutions & Products)