

**Internal Revenue Service**

Department of the Treasury  
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Date:

December 11, 2008

Legend:

Company =

State =

Dear :

This responds to your request for a ruling dated August 6, 2008, submitted on behalf of Company. Company requests a ruling that gain from certain hedging contracts will be treated as "other income" under section 851(b)(2) of the Internal Revenue Code of 1986, as amended (the "Code").

**FACTS**

Company is organized as a State corporation and has elected to be treated as a business development company under the Investment Company Act of 1940, 15 U.S.C. 80a-1 et seq., as amended (the "1940 Act"). Company is classified as a closed-end, non-diversified management investment company under the 1940 Act. Company has elected under section 851(b)(1) of the Code to qualify as a regulated investment company ("RIC") for federal income tax purposes.

On September 21, 2006, Company received Private Letter Ruling 200652013, which held that (1) gain recognized from the sale or other disposition of Production Payments is qualifying income from securities under section 851(b)(2), and (2) gains from derivative contracts entered into by Company to hedge its exposure on Production Payments are qualifying income under section 851(b)(2) because the income from the

derivative contract is “other income” derived with respect to Company’s business of investing in securities.

In Private Letter Ruling 200652013 Company represented that with respect to its hedging of any particular volumetric production payment, it would not enter into a swap or option contract involving more units than it expected to receive under such volumetric production payment. Company currently requests a ruling that gains from certain hedging contracts will be “other income” under section 851(b)(2) of the Code where the number of units hedged exceeds the number of units Company expects to receive under a particular volumetric production payment.

Company makes loans to small and mid-sized energy companies. These loans provide for a relatively high degree of risk. In addition to making loans in the form of traditional debt instruments, Company will make production payment loans (“Production Payments”). A Production Payment is a right to minerals in place that entitles its owner to a specified fraction of production for a limited period of time, or until a specified sum of money or specified number of units of mineral has been received. A Production Payment is limited in time or amount so that its duration is shorter than the producing life of the property which it burdens.

Company expects to purchase “carved-out” Production Payments which come in two forms: dollar-denominated Production Payments and volume-denominated Production Payments (commonly called “Volumetric Production Payments” (“VPPs”)). Dollar-denominated Production Payments give the holder the right to receive a certain percentage of production until it has received a fixed dollar amount plus interest. VPPs give the holder the right to receive a percentage of production from the property at regular intervals (e.g., monthly) until a specified quantity of production has been received.

The holder of a dollar-denominated Production Payment bears the risk that there will be inadequate payments from the property to repay the loan in its entirety. The holder does not bear price risk, however, because the price only affects the rate at which the loan is repaid. In contrast, the holder of a VPP is exposed to fluctuations in the price of the commodity and may receive the specified volumes at a much higher or lower price than expected.

To reduce its price exposure, Company will hedge its investments in the VPPs by entering into derivative contracts to lock in the commodity prices used to set the terms of the VPPs. The mechanism for hedging the commodity risk on the VPPs often will be swap contracts that will be entered into with investment grade counterparties.

A typical swap contract will be for a notional volume of the commodity (oil or gas) at a market index price. Under the swap contract, if the price of the commodity rises, Company agrees to pay the counterparty the difference over the spot price. If the price

of the commodity falls, Company expects to receive from the counterparty the difference from the spot price. The swap contract will provide for monthly payments over the term of the VPP.

Company may also enter into swap contracts whereby neither party makes a payment if the price fluctuates within a predetermined range. If the price varies beyond this range, then the parties will exchange payments as explained above. These swap contracts allow for some risk by permitting the price to float within a prescribed range; however, Company is able to hedge its exposure to significant price fluctuations.

Company may also obtain put options to hedge its price risk. A put option effectively places a floor on the price of the commodity that Company receives from the VPPs.

Company has determined that, with respect to certain VPPs, it cannot sufficiently hedge its commodity price risk without hedging more units of production than it expects to receive under the VPP. The need to hedge more units than are expected to be received under the VPP arises from the uncertainty regarding the rate at which it will be repaid. As a result, Company may hedge a total number of units in excess of the number of units it will receive under the VPP.

Company intends to identify each hedge as relating to a particular VPP in the same manner that a straddle is identified under section 1092(a)(2)(B). Company intends to make a clear and unambiguous identification of the hedge as relating to a particular VPP on its books and records on or before the close of the day in which Company enters into the hedge.

## LAW AND ANALYSIS

Section 851(a)(1)(B) defines a RIC, in part, as a domestic corporation that has in effect an election under the 1940 Act to be treated as a business development 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)(A) provides that, to qualify as a RIC, at least 90% of the RIC's 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 1940 Act), 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.

Rev. Rul. 2006-1, 2006-2 I.R.B. 261, as clarified by 2006-31, 2006-25 I.R.B. 1133, holds that certain derivative contracts with respect to a commodity index or an

individual commodity are not securities, that, in the circumstances described, the income generated from the derivative contract is not derived with respect to a RIC's business of investing in stocks, securities or currencies, and that, accordingly, the gains and other income from the derivatives are not qualifying income for purposes of section 851(b)(2).

Company enters into commodity-based swap contracts which are not securities. Nevertheless, Company's income from the swap contracts may be "other income" that is qualifying income if the swap contracts are entered into with respect to Company's business of investing in stocks, securities, or currencies. In Private Letter Ruling 200652013, we ruled with respect to Company's investment in VPPs that the gain from the sale or other disposition of the VPPs is qualifying income from securities under section 851(b)(2). Company represents that it enters into swap contracts only to hedge its price exposure with respect to its investments in VPPs. Accordingly, the swap contracts are directly related to Company's principal business of investing in securities.

Company also enters into option contracts to hedge its exposure on the oil and gas VPPs. The option contracts are directly related to Company's principal business of investing in VPPs.

Company enters into swap and option contracts to avoid exposure to changes in commodity prices rather than to create investment exposure to changes in commodity prices. Therefore, to the extent the Company enters into hedges to reduce exposure with respect to a particular VPP, income from the swap and option contracts will be qualifying income to Company for purposes of section 851(b)(2).

Furthermore, Company may purchase swap and option contracts on volumes in excess of the contractual volumes either: (1) prior to the receipt of any payments under the VPP, or (2) after payments have begun if Company determines that additional hedges are needed to fully protect Company from price fluctuations.

To determine whether Company's hedges actually diminish the risk of loss with respect to a particular VPP, it is helpful to refer to sections 246 and 1092. Although these sections are not controlling for purposes of section 851(b)(2), they provide useful guidance in interpreting substantially similar concepts arising under section 851(b)(2). Section 1.246-5 of the Income Tax Regulations (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.

Section 1.246-5(b)(1) of 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.

Company represents that it will enter into swap and option contracts on oil or gas in order to reduce or hedge the level of risk in their investment in VPPs and will identify each swap or option as a hedging instrument with respect to a particular VPP in the manner described in this letter. To the extent that, with respect to a particular VPP, a swap or option on oil or gas--

(1) consists of substantially similar or related property within the meaning of section 1.246-5(b)(1) of the regulations ((i) the fair market values of the VPP and the hedge will primarily reflect the performance of the same industry; and (ii) changes in the fair market value of the VPP are expected to approximate, directly or inversely, changes in the fair market value of the hedge, a fraction of the fair market value of the hedge, or a multiple of the fair market value of the hedge);

(2) is entered into to diminish the risk of loss, within the meaning of section 1.246-5 (b)(2) of the regulations, on a Company's investment (changes in the fair market values of the VPP and the hedge are expected to vary inversely); and

(3) is clearly identified on a Company's records as a hedging instrument with respect to the VPP, 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 (Company intends to make a clear and unambiguous identification of a hedge as relating to a particular VPP on its books and records on or before the close of the day in which the Company enters into the hedge);

gains derived from such swap and option contracts on oil or gas constitute other income derived with respect to Company's business of investing in stock, securities or currencies within the meaning of section 851(b)(2).

#### CONCLUSION

We rule that gains from the swap and option contracts as described above are qualifying income for purposes of section 851(b)(2) because the income from the derivative contracts is other income derived with respect to Company's business of investing in securities.

Except as specifically ruled upon above, we express no opinion on the federal tax consequences of the transactions described above under any other provisions of the Code and regulations. In particular, no opinion is expressed or implied with respect to the tax treatment of swap and option contracts on oil or gas 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 section 1.1092(b)-3T(d). Furthermore, no opinion is expressed concerning whether Company otherwise qualifies as a RIC under subchapter M, part I of the Code.

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

Sincerely,

Susan Thompson Baker  
Susan Thompson Baker  
Assistant to the Branch Chief, Branch 2  
Office of the Associate Chief Counsel  
(Financial Institutions & Products)