

## VIX in Sticks and VAX in Stacks

By John Kaufmann

John Kaufmann is of counsel at Greenberg Traurig LLP. He would like to thank John Prusiecki and Barbara Kaplan for comments on an earlier draft of this report.

In this report, Kaufmann argues that products based on the Chicago Board Options Exchange Volatility Index should be treated as securities, commodities, or other assets giving rise to qualifying income for federal income tax purposes.

The views expressed herein are those of the author and do not necessarily reflect those of Greenberg Traurig. Any mistakes are solely the author's.

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A non-monetary benefit of working in the capital markets industry is that it allows one to use abstract terms as though they denote concrete things, which causes cognitive dissonance in laymen. For example, it is common for traders to say that they “make a market” in X. Investopedia defines the term “market” as “a medium that allows buyers and sellers of a specific good or service to interact in

order to facilitate an exchange.”<sup>1</sup> Does this mean that a dealer who makes a market in, say, cattle futures constructs a trading pit or writes software code to match, buy, and sell orders? Of course not, but at first blush, it seems that it should mean that. A trader or dealer who makes a market in an asset presents bids and offers to the public in a way that allows her to function as a buyer or seller of last resort. By doing this, she creates the conditions that facilitate the existence of a market in that asset. Similarly, *pace* certain realtors in Greenwich, Connecticut, there is no physical “hedge fund space”; when traders and advisers discuss the hedge fund space (or the “energy space” or the “biotech space”), they are referring to a set of actors and transactions rather than a space where these actors sit or these transactions happen.

Of all these expressions, the one that causes the most cognitive dissonance to nonspecialists is “buying and selling volatility.” In statistics and in everyday discourse, the volatility of a value is the measure of the dispersion of returns or variance from the mean. The English term comes from the Latin *volare*, meaning to fly. The volatility of a value is the degree to which it flies around the mean. As such, the word denotes a concept that is no more concrete than “force,” “inertia,” or “mass.” How can you buy or sell inertia?

The answer is that when a trader says that she is buying or selling volatility, she means that she is buying or selling options. *Strictiore sensu*, when a trader says that she has bought volatility, she really means to say that she has entered into option positions whose value correlates directly with the perceived volatility of the underlier, and when she says that she has sold volatility, she means that she has entered into option positions whose value correlates inversely with the perceived volatility of the underlier. The correlation of option positions with volatility is discussed in more detail later, but often buying volatility simply means buying options and selling volatility means selling options.

The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a measure of perceived equity volatility in specified options on the Standard & Poor 500 index. When the VIX goes up,

<sup>1</sup>Available at <http://www.investopedia.com/terms/m/market.asp>.

traders who are long volatility in those options (and other correlated equity options) make money, and traders who are short volatility therein lose money. The opposite happens when the VIX goes down. In recent years, several different kinds of instruments that reference the VIX — including VIX-referenced futures contracts, VIX-referenced exchange-traded notes (ETNs), and VIX-referenced exchange-traded funds (ETFs) — have become popular among hedge fund managers. An unsettled question regarding VIX-based instruments is whether they constitute securities, commodities, or something else for federal income tax purposes. The question has practical significance in several different areas:

- *Effectively connected income.* If a U.S. nonresident is not engaged in a U.S. trade or business, it is not subject to federal income tax on any net income effectively connected to a U.S. trade or business.<sup>2</sup> Trading in securities or commodities (as defined in the code) by a non-dealer is not treated as a U.S. trade or business.<sup>3</sup> Therefore, if VIX-based instruments constitute securities or commodities for these purposes, merely trading in these instruments should not cause U.S. nonresidents to be engaged in a U.S. trade or business.
- *Publicly traded partnerships.* Partnerships whose interests are traded on an established securities market, or whose interests are readily tradable on a secondary market or the substantial equivalent thereof, are generally treated as corporations.<sup>4</sup> An exception to this rule exists for partnerships 90 percent or more of whose gross income consists of qualifying income,<sup>5</sup> which includes specified types of investment income.<sup>6</sup> If gain from VIX-related instruments is treated as qualifying income, it will count toward the 90 percent gross income requirement.
- *Regulated investment companies.* To qualify as a regulated investment company, a corporation must pass specific income, asset, and diversification tests.<sup>7</sup> Qualifying income generally consists of investment income, including dividends, interest, payments made on securities loans, and gain from the disposition of stock or securities.<sup>8</sup> If gain from VIX-related instruments falls within this category, income and

gain from VIX-referenced instruments can count toward the gross income requirement.

- *Unrelated business taxable income.* Organizations that are generally exempt from federal income tax under sections 401(a) and 501(c) are subject to tax on their unrelated business taxable income.<sup>9</sup> UBTI includes all income derived from any unrelated trade or business other than specified classes of income outlined in section 512(b).<sup>10</sup> Excluded income includes investment-type income such as dividends, interest, payments made on securities loans, gain from the sale of non-inventory assets, income from notional principal contracts, and gain from the lapse or termination of options to buy securities.<sup>11</sup> If gain from VIX-related instruments constitutes excluded income, it will not be treated as UBTI.

As discussed in more detail below, relevant law indicates that VIX-based products should be treated as securities, commodities, or other assets giving rise to qualifying income in the foregoing contexts. To reach this conclusion, it is necessary to review some facts, as well as the law.

## I. Facts

### A. Option Pricing

Generally, an option is a contract that grants the holder the right, but not the obligation, to buy or sell a specific asset (the underlier) at a specific price (the strike price) on or before a specific date (the maturity date). Some options (cash-settled options) provide for the payment of cash equal to the value of the option upon maturity or exercise, instead of purchase of the underlier. Other options (net-settled options) provide that the holder receive an amount of the underlier equal to the value of the option upon maturity or exercise instead of a cash or physical settlement. Some options (American-style options) allow exercise anytime before or at the maturity date. Other options (European-style options) allow exercise only at maturity.

Because an option grants the holder a right without a corresponding obligation, the purchaser of an option is required to pay his counterparty (the issuer or the writer of the option) consideration (a premium) to offset the counterparty's obligation to perform under the option contract. Options that grant the holder the right to buy the underlier at the strike price are call options (calls); options that grant the holder the right to sell the underlier at the

<sup>2</sup>Section 872(a)(2).

<sup>3</sup>Section 864(b)(2).

<sup>4</sup>Section 7704(a).

<sup>5</sup>Section 7704(c).

<sup>6</sup>Section 7704(d).

<sup>7</sup>Section 851(b).

<sup>8</sup>Section 851(b)(2)(A).

<sup>9</sup>Section 511(a).

<sup>10</sup>Section 512(a).

<sup>11</sup>Section 512(b)(1), (b)(5); reg. section 1.512(b)-1(a), -1(d)(2).

strike price are put options (puts). Standardized exchange-traded equity options generally grant the holder the right to buy or sell 100 shares of stock per contract. For example, a single call option contract on ABC stock would grant its holder the right to buy 100 shares of ABC stock at the applicable strike price, and a single put option contract on ABC stock would grant its holder the right to sell ABC stock at the applicable strike price.

Before maturity, an option's value may consist of one or both of two components. First, if an option would have value if it were to expire immediately, it is said to have intrinsic value. If a call option's strike price is less than the fair market value of the underlier, the call option has intrinsic value equal to the difference between those two values because a call option with a strike price lower than its underlier's FMV grants the holder the right to buy the underlier at a below-market price — the intrinsic value is the amount of the discount to FMV that the holder gains by owning the option. A call option does not have intrinsic value if its strike price is equal to or greater than the FMV of its underlier. By contrast, a put option has intrinsic value equal to the difference between its strike price and the FMV of its underlier to the extent that its strike price is greater than the FMV, but it does not have intrinsic value if its strike price is equal to or less than that FMV. The effect of the relationship between FMV and strike price on an option's intrinsic value is illustrated in tables 1 and 2 below. In each case, the strike price is \$100, and the underlier is 100 shares of XYZ stock.

Underlier FMV	Intrinsic Value
\$80	\$—
\$90	\$—
\$100	\$—
\$110	\$1,000
\$120	\$20,000

Underlier FMV	Intrinsic Value
\$80	\$2,000
\$90	\$1,000
\$100	\$—
\$110	\$—
\$120	\$—

Options that have intrinsic value are said to be “in the money.” Options that do not have intrinsic value are generally said to be either “at the money” (if their strike price is equal to the underlier's FMV) or “out of the money.”

Before maturity, all options have some value (option value) other than intrinsic value, attribut-

able to the probability that they will expire either in the money (for out-of-the-money and at-the-money options) or deeper in the money (for in-the-money options).

The value of an option is equal to the sum of its intrinsic value and its option value. Although there are several different methods to calculate the price of an option, every option pricing formula includes six inputs:

- strike price;
- price of the underlier;
- time to maturity;
- interest rate;
- dividends to be paid on the underlier (if any); and
- expected volatility of the underlier.<sup>12</sup>

And every option pricing formula produces the following outputs (referred to by traders as the “Greeks”):

- The theoretical value of the option. This is the price at which the option should be trading, given correct inputs. If the theoretical value of an option is greater than its market value, it is said to be undervalued; if its theoretical value is less than its market value, it is overvalued.
- Delta. An option's delta is a measure of the sensitivity of its value to changes in price of the underlier. For example, an option with a delta of 0.75 will increase in value by 75 cents for each \$1 increase in the price of the underlier, and an option with a delta of -0.75 will decrease by 75 cents for each \$1 increase in the price of the underlier. The absolute value of an option's delta is always greater than zero and less than 1 (although deltas approach those limits asymptotically as options move far out of the money or deep into the money).
- Lambda. An option's lambda is a measure of the percentage change in option value per percentage change in the price of the underlier. As such, it differs from delta in that delta is a measure of the relation of changes in gross option value to changes in gross underlier value, while lambda is a measure of relative percentage change.
- Theta. An option's theta is a measure of the sensitivity of its value to the passage of time. The longer the time to maturity, the greater the probability that the option will be in the money (or deeper in the money) at or before maturity.

<sup>12</sup>Note that expected volatility is not the same as historical volatility. For example, a stock with very low historical volatility may have a high expected volatility before an earnings release date or if a major news story is anticipated soon.

Therefore, an option's value decreases, or "decays," with the passage of time. Theta measures the rate of this decay.

- Rho. An option's rho is a measure of the sensitivity of its value to changes in the interest rate.<sup>13</sup>
- Vega. An option's vega is a measure of the sensitivity of its value to changes in expected future volatility in the price of the underlier.
- Gamma. An option's gamma is a measure of the sensitivity of its delta to changes in the value of the underlier. Gamma differs from the other outputs listed above in that it is a second-order derivative; instead of measuring the impact of one of the pricing inputs on an option's value, it measures the effect of one of the pricing inputs on another one of the outputs.

The foregoing is not an exhaustive list of possible option pricing outputs. Sophisticated traders may use a long list of second- and even third-order derivatives to value their option positions. Nevertheless, it is sufficient for this discussion.<sup>14</sup>

Of the six inputs, expected future volatility is unique because it is the only value that is not known as of the pricing date.<sup>15</sup> This has two practical effects for the option trader:

- First, because any model is only as good as its inputs, any option pricing model is only as good as its user's estimate of future volatility. This injects an element of art into the science of

option pricing; an incorrect estimate of future volatility will make the best-designed pricing model inaccurate.

- Second, if an option's actual price (as opposed to its theoretical value) is known at the time of valuation, it is possible to calculate the option's implied volatility. This is the value implied if an option's actual price and all inputs other than volatility are known and an option pricing model is assumed to be accurate. Effectively, it is the number produced by plugging the actual price and all known inputs into the applicable pricing model and solving for volatility. Most standard option pricing software programs list the implied volatility of an option, along with its theoretical value and its Greeks.

## B. The VIX

Options have a long history. In *The Politics*, Aristotle tells the story of the philosopher Thales of Miletus, who paid what was essentially an option premium to have exclusive use of the olive presses in Miletus and Chios during an upcoming harvest season.<sup>16</sup> Options on tulips were traded during the Dutch "tulip mania" of 1636,<sup>17</sup> and options on commodities have been traded on American commodity exchanges since the first half of the 20th century.<sup>18</sup> Equity options have been traded over the counter in the United States since the late 19th century, and the trading of listed equity call options on American equities began when the CBOE first opened in 1973.<sup>19</sup> Equity put options were added in 1977, and options on broad-based indices, including the S&P 500 index, were added in 1983.<sup>20</sup> Since its inception, the volume of exchange-listed option

<sup>13</sup>Interest rates affect option premiums because they affect the cost of hedging an option position.

<sup>14</sup>Most option pricing formulas used today are variations of the Black-Scholes model. See Fischer Black and Myron Scholes, "The Pricing of Options and Corporate Liabilities," 81 *J. Polit. Econ.* 637 (1973). It is not known why Black and Scholes chose the name "vega" for the output that measures sensitivity to expected future volatility. One theory is that they wanted each output to bear the name of a Greek letter whose English transcription began with a letter similar to the initial letter of the name of the factor the output measures ("rho" — "rate," "theta" — "time," etc.). The authors apparently were unable to think of a Greek letter whose English transcription begins with a "v" or signifies the "v" sound. In fact, in earlier dialects of ancient Greek, the letter digamma (Ϝ) was used to denote the "w" or "v" sound. Although it dropped out of the language by the classical period, traces of it can be found in Homeric meter in phonemic environments in which the "v" or "w" consonant is preserved in Indo-European cognates (e.g., Greek, "[Ϝ]οῖδα," "I know"; Latin, "video," "I see"; English, "wisdom"; and Czech, "vědět," "to know," etc.). The "v" sound is denoted by the letter beta (β, pronounced "veeta") in modern Greek. The story is that Scholes owned a Chevrolet Vega when the original article was written, and the authors used the name of the car as a proxy for a Greek letter in early drafts and never changed it.

<sup>15</sup>For purposes of this discussion, it is assumed that future dividends are known as of the valuation date. Although actual dividend payments may in some cases diverge from expected payments, the net effect of those fluctuations tends to be de minimis.

<sup>16</sup>Aristotle, *The Politics*, at 1.1259a:

Thales, so the story goes, because of his poverty was taunted with the uselessness of philosophy; but from his knowledge of astronomy he had observed while it was still winter that there was going to be a large crop of olives, so he raised a small sum of money and paid deposits for the whole of the olive-presses in Miletus and Chios, which he leased at a low rent because he was not competing with anyone; and when the season arrived, there was a sudden demand for a number of presses at the same time, and by leasing them out on what terms he liked, he made a considerable sum of money, so proving that it is easy for philosophers to be rich if they choose, but this is not what they are about.

<sup>17</sup>Earl A. Thompson, "The Tulipmania: Fact or Artifact?" 130 *Pub. Choice* 99 (2007).

<sup>18</sup>See, e.g., the legislative history of the Commodity Futures Trading Commission Act of 1974, H.R. 93-975, discussed in more detail below.

<sup>19</sup>See history of the CBOE, available at <http://www.cboe.com/aboutcboe/History.aspx>.

<sup>20</sup>*Id.*

trading, particularly in liquid instruments such as options on the S&P 500 index, has grown exponentially.<sup>21</sup>

Because of the importance of volatility in option pricing and the increase in option trading volume in the 1980s, academics and market participants during that time suggested that an objective measure of expected volatility as reflected in current option prices would be useful.<sup>22</sup> In response, the CBOE created the VIX in 1993. The CBOE has calculated and published the VIX in real time since then. The level of the VIX at any given time is equal to a weighted average of the sum of the price of all near-term and second-to-near-term out-of-the-money puts and calls on the S&P index, adjusted to account for interest rates, time to maturity, distance from the money, and the size of intervals between strike prices. For the non-arithmetic reader, the formula for calculating the VIX is as follows:

$$\sigma^2 = 2/T \sum_i \Delta K_i / K_i^2 e^{RT} Q(K_i) - 1/T[(F/K_0) - 1]^2$$

where

$\sigma$  is VIX/100.

T is time to expiration.

F is the forward index level derived from option prices.

$K_0$  is the first strike below the forward index level, F.

$K_i$  is the strike price of the  $i$ th out-of-the-money option (a call if  $K_i > K_0$ , a put if  $K_i < K_0$ , and both a put and a call if  $K_i = K_0$ ).

$\Delta K_i$  is the interval between strike prices — that is, half the difference between the strike on either side of  $K_i$ .  $\Delta K$  for the lowest strike is the difference between the lowest strike and the next-highest strike.  $\Delta K$  for the highest strike is the difference between the highest strike and the next-highest strike.

R is the risk-free interest rate to expiration.

$Q(K_i)$  is the midpoint of the bid-ask spread for each option with a  $K_i$ .<sup>23</sup>

Stated qualitatively, the VIX represents an average of near- and next-to-near-term option prices, adjusted to remove the effect of inputs other than expected volatility.

Note two things in light of the foregoing:

- The VIX is not the same as implied volatility. Implied volatility is the value that an option pricing formula produces if one plugs in all known pricing inputs and actual prices and solves for volatility. By contrast, the VIX represents the prices of actual options, adjusted to offset the effect of pricing inputs other than volatility. Implied volatility is a made-up, model-dependent value, while the VIX represents actual option prices, adjusted to remove the effects of specific pricing inputs.
- In practice, the VIX represents more than volatility; it represents everything that affects the overall price of options on the S&P index other than distance from the money, time to expiration, and the interest rate. Although it is called an index of volatility, it is really an index of option value, stripped of some inputs. Although this value is generally attributed to expected future volatility, fluctuations in the level of the VIX may be attributable to any factor other than the excluded pricing inputs.<sup>24</sup>

### C. VIX-Referenced Instruments

After the creation of the VIX in 1993, there was demand for an instrument by which investors could obtain direct exposure to it, both as a means of hedging volatility risk and as a separate asset class. In response, the CBOE introduced futures contracts on the VIX in 2004. That in turn led to the creation of ETFs and ETNs that reference VIX futures.

**1. VIX futures.** VIX futures are cash-settled futures contracts that reference the VIX. When a party enters into a long position in a VIX futures contract, he gains the right to be paid the difference between the level of the VIX at expiration and the forward price<sup>25</sup> of the VIX when the contract was entered into multiplied by \$1,000, if the level at expiration exceeds the forward price; and he agrees to pay his

<sup>24</sup>In fact, the level of the VIX is negatively correlated with the value of the S&P 500 index. When the value of the S&P 500 index falls, the value of the VIX tends to rise. This is because equity investors tend to have a long bias — *i.e.*, investors hold more long positions in shares in the S&P 500 index than they do short positions. Long positions in the underliers tend to be hedged by long positions in puts; therefore, when the stock index falls, the value of puts rises. Call prices are affected by the increase in put prices because an underpricing of calls would result in an arbitrage opportunity when a trader shorts the underlier, sells an at-the-money put, and buys an at-the-money call. This directional bias is less pronounced in measures of volatility as reflected in options on non-equity underliers.

<sup>25</sup>Generally, the forward price is equal to the current price of the VIX plus an interest component that represents the value of cash saved by the long party to the contract by gaining exposure to the VIX before expiration. However, the forward price may also reflect market sentiment regarding future volatility independent of the current price or interest cost.

<sup>21</sup>For a visual representation of the growth of the volume of listed option trading from 1973 through 2012, see, *e.g.*, <http://www.cboeoptionshub.com/cboe40/volume-chart/>.

<sup>22</sup>See, *e.g.*, Menachem Brenner and Dan Galai, "New Financial Instruments for Hedging Changes in Volatility," 45 *Fin. Anal. J.* 61 (July/Aug. 1989).

<sup>23</sup>Available at <https://www.cboe.com/micro/vix/vixwhite.pdf>.

counterparty that amount if that level is less than the forward price. By contrast, when a party enters into a short position in a VIX futures contract, he gains the right to be paid the difference between the forward price and the level of the VIX at expiration multiplied by \$1,000, if that level is less than the forward price; and he agrees to pay his counterparty that amount if that level is greater than the forward price. Table 3 shows the returns at maturity to the long and short parties on a single VIX futures contract with a forward price entry of 12 in five different pricing scenarios.

	11	11.50	12	12.50	13
Long party	-\$1,000	-\$500	\$—	\$500	\$1,000
Short party	\$1,000	\$500	\$—	-\$500	-\$1,000

As illustrated, unlike option contracts, every futures contract is a zero-sum game. In every payout scenario, any amount gained by the long party to a futures contract is equal and opposite to short-party losses and vice versa.

Futures contracts are “intermediated” by an exchange. To participate in the futures market, investors open an account with a broker who is a member of a futures exchange. When an investor enters into a futures contract, she enters into a futures contract with her broker. Her broker enters into an offsetting contract with the exchange, and the exchange in turn enters into an offsetting contract with another investor’s broker. Brokers are required to post margin (effectively, a performance bond) equal to a small percentage of the current forward price of the underlying. Minimum required margin is marked to market with reference to changes in the forward price, and market participants are required to post additional margin or may be allowed to withdraw cash from their margin account accordingly.

VIX futures contracts are traded on the CBOE Futures Exchange (CFE), a limited liability company wholly owned by CBOE Holdings Inc., a Delaware corporation that also owns the CBOE. The CFE is a designated contract market, as defined in the Commodity Exchange Act,<sup>26</sup> and is regulated by the Commodity Futures Trading Commission.

**2. VIX ETFs.** ETFs were first launched in 1993, with the issuance of shares in the State Street SPDR S&P 500 ETF trust (the SPY). An ETF is a closed-end fund whose investment portfolio is designed to give

its owners exposure to a stated index, basket, or trading strategy. In the early days, ETFs were generally designed to provide investors exposure to broad-based indices. For example, the SPY is a trust that holds a portfolio of assets whose composition mimics that of the S&P 500 index. Because investors have a right to a percentage of the trust’s net asset value (NAV) upon liquidation, owners of the SPY effectively have economic exposure similar to that of investors who own a portfolio comprising all the shares in the S&P 500 index. Most ETFs are RICs for federal income tax purposes. As such, they are treated as corporations, although they may qualify for an exemption from entity-level taxation if specific investment and income distribution requirements are met.<sup>27</sup>

After the first wave of broad-based ETFs like the SPY, ETFs that gave investors exposure to narrower asset baskets began to be issued. VIX ETFs were first issued in 2011.<sup>28</sup>

VIX ETFs issue ownership interests and use the proceeds of those issuances to finance positions in VIX futures and other derivatives indexed to the VIX.<sup>29</sup> Generally, VIX ETFs reference one of two indices — the S&P 500 VIX Short-Term Futures Index (the short-term index) or the S&P 500 VIX Mid-Term Futures Index (the mid-term index). Both the short-term index and the mid-term index reflect the return that an investor would have if he invested in a given basket of VIX futures. The short-term index is constructed to provide exposure to a basket of near-month and next-to-near-month VIX futures contracts that are weighted to produce a constant weighted average maturity of one month. Futures positions in the index are continuously replaced, or “rolled,” to ensure that this weighted average maturity remains constant at one month. The mid-term index is made up of fourth-, fifth-, sixth-, and seventh-month VIX futures contracts that are weighted to produce a constant weighted average maturity of five months.

<sup>27</sup>Sections 851(a), 852(a), and 852(b)(3).

<sup>28</sup>See, e.g., ProShares Ultra VIX Short-Term Futures ETF, ProShares Short VIX Short-Term Futures ETF, and ProShares VIX Short-Term Futures ETF.

<sup>29</sup>One recently introduced type of VIX ETF departs from this model. Unlike the VIX ETFs discussed above, the AccuShares Commodities Trust I ETF provides holders of its shares access to the “spot VIX.” To do this, it issues two different classes of shares (Up Shares and Down Shares), each with the same number of shares outstanding. Cash collected from subscribers is allocated to the Up class or the Down class with reference to fluctuations in the value of the VIX. Holders of a class of shares can access cash allocated thereto either through distributions or through changes in the shares’ liquidation preference. The trust holds only cash and cash equivalents and is treated as a corporation for federal income tax purposes.

<sup>26</sup>7 U.S.C. section 7b-7.

VIX ETFs can provide direct, inverse, or leveraged exposure relative to the reference index. The value of interests in direct VIX ETFs varies in direct proportion to the level of the reference index. The value of interests in inverse VIX ETFs varies inversely with the level of the index, and the value of interests in leveraged VIX ETFs varies directly with the level of the index and a stated multiplier. For example, if the level of the relevant index were to increase by 1 point, the value of interests in a direct VIX ETF would increase by 1 point, that of interests in a non-leveraged inverse VIX ETF would decrease by 1 point, that of a 2x leveraged direct VIX ETF would increase by 2 points, and that of a 2x leveraged inverse ETF would decrease by 2 points.

VIX ETFs usually hold their assets in cash and cash equivalents and enter into derivative contracts. Cash equivalents generally constitute Treasury bills, money market instruments, and other short-duration debt instruments. Derivatives include VIX futures and some swaps that reference VIX futures indices. A holder of an ETF interest has the right to have the ETF redeem its interest in exchange for a pro rata share of the ETF's NAV.

Some VIX ETFs maintain that they qualify as RICs under section 851(a).<sup>30</sup> As discussed above, those VIX ETFs are treated as corporations for federal income tax purposes. Some other VIX ETFs maintain that they are treated as partnerships for federal income tax purposes.<sup>31</sup>

VIX ETFs are listed and traded on the New York Stock Exchange Arca, which is under the supervision of the SEC.

**3. VIX ETNs.** Beginning in 2006, some banks began to issue ETNs.<sup>32</sup> An ETN has a maturity date and is an unsecured obligation of its issuer, backed only by the credit of its issuer. ETNs are designed to give investors access to the returns of various market benchmarks, reflected in a designated index or trading strategy. When an investor buys an ETN, the issuer promises to pay the amount reflected in the index or strategy (minus fees) upon maturity. Because ETNs reference a notional index rather than granting interest holders the right to a portion

of the issuer's NAV, they are not subject to the tracking risk that may affect ETFs.<sup>33</sup>

ETNs that reference the VIX were first issued in 2009.<sup>34</sup> VIX ETNs all reference indices designed to replicate the return on a basket of VIX futures contracts with a constant weighted average maturity. VIX ETNs generally provide holders a return consisting of two components: a performance component, calculated with reference to price changes in the VIX futures contracts that make up the relevant index or indices; and an interest component, which reflects an interest-like return on the VIX ETN's principal amount. For VIX ETNs that reference a total return index, the interest rate is included in the value of the index itself. The interest rate is calculated to reflect accruals of interest on a notional principal amount, determined based on the value of the index at a rate equal to the yield on near-term, three-month Treasury bills and reinvestment thereof in the relevant index or indices.<sup>35</sup> For VIX ETNs that reference non-total return indices, the return on the ETN itself provides for interest accruals on its notional amount at a rate equal to the yield on near-term, 28-day Treasury bills and reinvestment thereof in the relevant index or indices.<sup>36</sup> As in the case of VIX ETFs, holders of VIX ETNs may receive direct, inverse, or leveraged exposure to the VIX. Holders of VIX ETNs have no right to a return of principal.

## II. Third- or Fourth-Order Derivatives

One feature the VIX-referenced instruments described above all share is that they are all third- or fourth-order derivatives. Generally, a derivative is a financial instrument that derives its value from an underlying asset or index.<sup>37</sup> As discussed, the VIX

<sup>33</sup>Tracking risk is the risk that an ETF's fund manager will not manage the ETF's investments in a manner that perfectly tracks the target index. For example, if the manager of the SPY rebalances his portfolio only periodically, there is a risk that the portfolio may not perfectly track the basket of stocks that make up the S&P 500 index between the rebalancing dates. Because an ETN is not backed by an actual portfolio of assets, this risk does not apply to ETNs.

<sup>34</sup>iPath S&P 500 VIX Short-Term Futures ETN (VXX) and iPath S&P 500 VIX Mid-Term Futures ETN (VXZ).

<sup>35</sup>See VXX and VXZ, *supra* note 34.

<sup>36</sup>See, e.g., iPath Inverse S&P 500 VIX Short-Term Futures ETN.

<sup>37</sup>See, e.g., Stevie Conlon and Vincent Aquilino, *Principles of Financial Derivatives: U.S. and International Taxation*, at A1.01[3], n.11 and sources therein; David H. Shapiro, *Taxation of Equity Derivatives* (Portfolio 188), at I (a derivative is an instrument that "provides an investment return that is linked to or 'derived' from the value of a direct equity investment without conveying (or divesting) legal ownership of the underlying . . . investment itself"); and N.Y. Ins. Law section 1401 (defining derivative for New York insurance regulatory law purposes — similarly).

<sup>30</sup>See, e.g., First Trust CBOE S&P 500 VIX Tail Hedge Fund (VIXH).

<sup>31</sup>See, e.g., ProShares Ultra VIX Short-Term Futures ETF, ProShares Short VIX Short-Term Futures ETF, and ProShares VIX Short-Term Futures ETF.

<sup>32</sup>The first two ETNs to be issued were the iPath S&P GSCI Total Return Index ETN, which tracked the value of the S&P GSCI Total Return Index, and the iPath S&P GSCI Crude Oil Total Return Index ETN, which tracked the value of the S&P GSCI Crude Oil Total Return Index.

derives its value from the values of options on the S&P 500 index. Those options, in turn, derive their value from the value of shares in the S&P 500 index. VIX futures derive their value from the VIX, and VIX ETFs and ETNs, in turn, derive their value from VIX futures. Therefore, VIX futures are third-order derivatives on the S&P 500 index, and VIX ETFs and ETNs are fourth-order derivatives thereon. However, even though these instruments are three to four layers deep, their value correlates with, and is referenced to, the performance of the underlying shares and options.

### III. Uses of VIX-Referenced Instruments

As with any derivative contract, investors may use VIX-referenced instruments for one of three purposes: hedging, speculation, or arbitrage.

#### A. Hedging

Positions in VIX-referenced instruments may be used to hedge positions that an investor holds in connection with another investment strategy. For example, a trader who sells volatility to collect option premiums will generally have short vega (that is, the value of her positions will decrease if expected volatility increases). The trader may hedge this risk by entering into long positions in VIX-referenced instruments. Therefore, VIX-referenced instruments allow option traders to hedge one of their position Greeks without affecting other position Greeks. VIX-referenced instruments are also used by investors who only hold positions in underlying shares to hedge price risk. Because the VIX tends to correlate negatively with the price of the S&P 500 index, pure long investors may (and often do) enter into positions in VIX-referenced instruments to hedge against sharp market declines.

#### B. Speculation

Investors may also treat volatility as an asset class. Investors who do this simply take positions in VIX-referenced instruments with a view to changes in the future value thereof. This is similar to investors making directional bets regarding the value of stocks, commodities, or debt instruments.

#### C. Arbitrage

Investors also use VIX-referenced instruments to profit from pricing inefficiencies in correlated instruments. For example, if an investor sees that shares of a VIX ETF are underpriced relative to its NAV, he may purchase shares in it and enter into short positions in a corresponding basket of VIX futures contracts. By contrast, if an investor sees that shares of a VIX ETF are overpriced relative to its NAV, he may sell shares in it short and enter into long positions in a corresponding basket of VIX futures contracts.

### IV. Applicable Law

The treatment of the foregoing under different tax regimes is discussed below.

#### A. Effectively Connected Income

Although courts and the IRS have not addressed the issue directly, existing authority indicates that trading in most VIX-referenced instruments by a U.S. nonresident should not cause it to be treated as engaged in a trade or business within the United States.

Generally, U.S. nonresidents are subject to federal income tax on a net basis for income effectively connected with a trade or business within the United States.<sup>38</sup> A U.S. nonresident not engaged in a trade or business within the United States is not subject to federal income tax on a net basis.<sup>39</sup> Neither the code nor applicable Treasury regulations provide a comprehensive definition of the term “trade or business within the United States” for these purposes. However, section 864(b)(2) specifies that trading in stocks, securities, or commodities in the United States generally does not constitute a trade or business within the United States (the stock or securities safe harbor and the commodities safe harbor, respectively).<sup>40</sup> Further, proposed regulations have extended a similar safe harbor to non-dealer taxpayers that trade specified derivatives on securities or commodities in the United States (the derivatives safe harbor).<sup>41</sup>

Under the stocks and securities safe harbor, a U.S. nonresident is not deemed to be engaged in a trade or business within the United States merely because it trades in stocks or securities through a resident broker, commission agent, custodian, or other independent agent.<sup>42</sup> This exemption applies to U.S. nonresident dealers in securities, as well as to U.S. nonresidents that are not securities dealers.<sup>43</sup> Furthermore, a U.S. nonresident that is not a dealer in stocks or securities is not treated as engaged in a U.S. trade or business because it trades stocks or securities for its own account, whether by the taxpayer, its employees, or any other independent or dependent agent, regardless of whether the agent has discretionary authority to make decisions in carrying out the transactions.<sup>44</sup> This second exemption permits a narrower class of U.S. nonresidents (that is, non-dealers) to engage in a broader range of activities (that is, trading for the taxpayer’s account,

<sup>38</sup>Sections 872(a)(2) and 882(a)(1).

<sup>39</sup>*Id.*

<sup>40</sup>Section 864(b)(2).

<sup>41</sup>Prop. reg. section 1.864(b)-1(a), REG-106031-98.

<sup>42</sup>Section 864(b)(2)(A)(i).

<sup>43</sup>*Id.*

<sup>44</sup>Section 864(b)(2)(A)(ii).



whether through brokers, independent agents, employees, or dependent agents). The two similar rules that make up the commodities safe harbor exempt U.S. nonresidents that trade commodities in the United States.<sup>45</sup>

For purposes of the stock or securities safe harbor, securities are debt instruments and specified rights with respect thereto.<sup>46</sup> Trading in stocks or securities for these purposes includes trading in shares of stock, equity options, and other contracts to buy or sell stocks or securities, as well as engaging in activities that are ancillary thereto.<sup>47</sup> The IRS has interpreted the “ancillary activities” category broadly. For example, in unpublished guidance, the IRS has ruled that entry into interest rate swaps used to hedge risks associated with a portfolio of securities is an ancillary activity and hence is covered under the stock or securities safe harbor.<sup>48</sup> It has also ruled that entry into securities loans in the United States does not constitute a trade or business within the United States because that activity is closely related to the trading of stocks and securities in the United States.<sup>49</sup>

The definition of a commodity for purposes of the commodities safe harbor is both broader and less intuitive than the definition of stocks or securities. Generally, an asset constitutes a commodity only if it is of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated thereon, although the term does not include goods or merchandise in the ordinary channels of commerce.<sup>50</sup> The IRS has consistently interpreted the term “commodity” in this context to include any instrument listed on an exchange regulated by the CFTC.<sup>51</sup> This definition differs from the lay definition of a commodity as a fungible tangible good used as an input for manufacturing or consumption both because it allows contracts on intangible underliers to be

treated as commodities and because the identity of the governmental body that regulates the exchange on which a contract is traded, rather than the nature of the underlying asset itself, is the dispositive factor in determining whether the contract constitutes a commodity.

The IRS examined the commodities trading safe harbor in LTR 8540033 and other private rulings, which reached the same conclusion.<sup>52</sup> The taxpayer in LTR 8540033 was a foreign corporation that sought to enter into futures contracts on Eurodollar time deposits, the S&P 500 index, and the COMEX 500 stock index. The IRS determined that trading in those contracts constituted trading in commodities for purposes of the safe harbor.

In so ruling, the IRS first examined the history of the relevant regulatory law. Under the Grain Futures Act of 1922 (revised and renamed the Commodity Exchange Act in 1936), the term “commodity” was defined by reference to a finite list of tangible products.<sup>53</sup> By contrast, the definition of the word in the Commodity Futures Trading Commission Act of 1974 was expanded to include “all other goods and articles, except onions, and all other services, rights and interest in which contracts for future delivery are presently or in the future dealt.”<sup>54</sup> The expanded definition was intended to cover futures markets involving nontraditional goods and services.<sup>55</sup>

Although the definition of commodity was expanded, the 1974 act also imposed some restrictions on the designation of exchanges as contract markets to prevent those exchanges from being used for mere gambling. Under the 1974 act, for a board of trade to be designated as a contract market, it had to demonstrate that the contracts traded on it met an economic purpose test.<sup>56</sup> To satisfy this test, the board of trade had to demonstrate that either (1) the prices involved in transactions for future delivery in the commodity are, or reasonably can be expected to be, generally quoted and disseminated as a basis for determining prices to producers, processors, merchants, or consumers of the commodity or the products or byproducts thereof; or (2) the transactions are, or reasonably can be expected to be, used by producers, processors, merchants, or consumers engaged in handling the commodity (including the products, byproducts, or source commodity

<sup>45</sup>Section 864(b)(2)(B)(i) and (ii).

<sup>46</sup>Reg. section 1.864-2(c)(2) (“For purposes of this paragraph, the term ‘securities’ means any note, bond, debenture or other evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.”).

<sup>47</sup>*Id.* (“The effecting of transactions in stocks or securities includes buying, selling (whether or not by entering into short sales), or trading in stocks, securities or contracts to buy stocks or securities . . . and any other activity closely related thereto (such as obtaining credit for the purpose of effecting such buying, selling, or trading).”).

<sup>48</sup>LTR 9204015.

<sup>49</sup>LTR 9041011.

<sup>50</sup>Section 864(b)(2)(B)(iii); reg. section 1.864-2(d)(3).

<sup>51</sup>*See, e.g.*, Rev. Rul. 73-158, 1973-1 C.B. 337 (off-exchange transactions in raw sugar were treated as trading in commodities for relevant purposes because a commodity is any type of commodity traded on a commodity exchange or any futures contract thereon).

<sup>52</sup>*See also* LTR 8813012, LTR 8850041, and LTR 8807004.

<sup>53</sup>42 Stat. 998 ch. 369; 49 Stat. 1491 ch. 545.

<sup>54</sup>P.L. 93-463; 7 U.S.C. section 1a(9) (definition of commodity). Trading in onion futures was prohibited by the Onion Futures Act of 1958, 7 U.S.C. section 13-1.

<sup>55</sup>H.R. 93-975, 44-45 (1974).

<sup>56</sup>1974 act, 208 (former 7 U.S.C. section 7a, repealed by the Commodity Futures Modernization Act of 2000, P.L. 106-554).

thereof) in interstate commerce as a way to hedge against possible loss through price fluctuations.<sup>57</sup>

The IRS noted that stock index futures contracts and eurodollar deposit futures contracts may fulfill the economic purpose test because taxpayers may enter into these contracts to hedge against the risk of fluctuations in the value of ordinary assets. The IRS then ruled that the fact that a contract is traded on a regulated futures market means that it is a commodity in the ordinary financial sense, as required under prior published guidance.<sup>58</sup> Although the reasoning in the ruling is elliptical, it appears that the IRS's view was that listing on a CFTC-regulated exchange should be treated as a proxy for status as a commodity in the ordinary financial sense, both because the definition of commodity for regulatory purposes is broad enough to include some nontraditional commodities and because contracts that are mere gambling bets are excluded from those exchanges.

The IRS has also ruled that in cases of overlap, in which an instrument such as a futures contract on a Treasury bill qualifies as both a contract to buy or sell a security and a futures contract, it should be treated under the stocks or securities safe harbor rather than the commodities safe harbor.<sup>59</sup> Under current law, the distinction is moot because status as either type of instrument will qualify a U.S. nonresident for one of the two safe harbors. Private guidance issued under previous law seems to indicate that this general rule should not be used to prevent taxpayers from claiming commodity status in overlap cases when they could not benefit from the stocks or securities safe harbor.<sup>60</sup>

Proposed regulations issued in 1998 put the derivatives safe harbor in place.<sup>61</sup> Although the proposed regulations will be effective for tax years beginning 30 days after the date the final regulations are published in the *Federal Register*, taxpayers engaged in derivative transactions before the effective date may take any reasonable position regarding the treatment thereof under the existing safe harbors, and positions consistent with the existing

proposed regulations are considered reasonable.<sup>62</sup> The proposed regulations state that if a taxpayer is an eligible non-dealer, the term "engaged in a trade or business within the United States" does not include effecting transactions in derivatives for the taxpayer's own account.<sup>63</sup> A derivative is defined as evidence of an interest, or a derivative financial instrument (including any option, forward contract, short position, and any similar instrument), in any of the following:

- a commodity (as the term is used in section 864(b)(2)(B) and reg. section 1.864-2(d));
- a share of stock;
- a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; or
- a note, a bond, a debenture, or any other evidence of indebtedness.<sup>64</sup>

This definition is somewhat circular because it defines a derivative as, *inter alia*, a derivative financial instrument in one of an enumerated set of underlier categories without defining the term "derivative financial instrument." Stated otherwise, the word "derivative" appears to be defined in terms of the word "derivative." If the rule adds information, it does so by limiting the definition of derivative to the subset of derivative financial instruments that reference stocks, commodities, specified partnership interests, and debt instruments. Commentators have generally defined a derivative or a derivative financial instrument as an instrument whose value is linked to, or derives from, the value of another instrument, without granting the holder of the derivative a current ownership interest in the underlier.<sup>65</sup> Therefore, the best reading of the proposed regulations appears to be that the safe harbor extends to derivative instruments as commonly understood, including options, futures, forwards,

<sup>62</sup>*Id.* ("For periods prior to the effective date, taxpayers engaged in derivative transactions may take any reasonable position with regard to the section 864(b)(2)(A)(ii) and (B)(ii) safe harbors. Positions consistent with these proposed regulations will be considered reasonable.")

<sup>63</sup>*Id.* For these purposes, an eligible non-dealer is (1) a dealer in stocks or securities as defined in reg. section 1.864-2(c)(2)(iv)(a); (2) "a dealer in commodities" as the term is used in reg. section 1.864-2(d); or (3) a person that regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in derivatives with customers in the ordinary course of a trade or business, including regularly holding itself out, in the ordinary course of its trade or business, as being willing and able to enter into either side of a derivative transaction.

<sup>64</sup>*Id.*

<sup>65</sup>*See* Conlon and Aquilino, *supra* note 37; and Shapiro, *supra* note 37.

<sup>57</sup>LTR 8540033.

<sup>58</sup>*Id.*, citing Rev. Rul. 73-158.

<sup>59</sup>LTR 8527041 (Because physically settled futures contracts on debt instruments are "evidences of" or a "right to subscribe to" securities, they are securities for relevant purposes, even though they are traded on a CFTC-regulated contract market.)

<sup>60</sup>LTR 8807004 (Taxpayer with a principal office in the United States can benefit from the application of the commodities safe harbor in gain from trading in futures on debt instruments, even though those contracts are also securities for relevant purposes and the stocks or securities safe harbor when the ruling was issued did not apply to taxpayers with a principal office in the United States.)

<sup>61</sup>REG-106031-98; prop. reg. section 1.864(b)-1.

and notional principal contracts on stock, securities, commodities, and some widely traded partnership interests.

Given the foregoing, it appears clear that VIX futures should be treated as commodities for purposes of the relevant safe harbors. VIX futures are listed and traded on the CFE. The CFE is a designated contract market regulated by the CFTC; therefore, VIX futures contracts traded thereon should be commodities for purposes of the commodities safe harbor.

VIX futures should also be treated as derivatives for purposes of the derivatives safe harbor. As discussed above, the VIX is a measure of the average prices of near- and next-to-near-term options on the S&P 500 index, with factors such as intrinsic value, time to expiration, distance from the money, and the risk-free interest rate stripped out. It is not a made-up number; it represents a real slice of real option prices. Trading in equity options is treated as trading in stocks for purposes of the stocks or securities safe harbor.<sup>66</sup> Therefore, since a VIX futures contract is a derivative financial instrument on stocks, it should constitute a derivative within the meaning of the derivative safe harbor.

VIX-referenced ETFs and ETNs present slightly different issues. As discussed in more detail below, gain or loss from VIX futures contracts should constitute good RIC income, as well as qualifying income of a publicly traded partnership. If a VIX ETF successfully elects to be treated as a RIC, it should be treated as a corporation for federal income tax purposes.<sup>67</sup> Trading in shares of such an ETF should be treated as simply trading in stocks for purposes of the stocks or securities safe harbor. Trading in interests in VIX ETFs treated as partnerships for federal income tax purposes should qualify under either the stocks or securities safe harbor or the commodities safe harbor, as long as assets owned by the ETF constitute stocks, securities, or commodities, and the partnership is not a dealer therein.<sup>68</sup>

<sup>66</sup>Reg. section 1.864-2(c)(2)(i) (“The effecting of transactions in stocks or securities includes buying, selling . . . or trading in . . . options to buy or sell stocks or securities.”).

<sup>67</sup>Section 851(a).

<sup>68</sup>Reg. section 1.864-2(c)(2)(ii) (Ownership of an interest in a partnership should not cause a U.S. nonresident to be treated as engaged in a trade or business within the United States solely because the partnership effects transactions in the United States in stock or securities for its own account); reg. section 1.864-2(d)(2)(ii) (similar, regarding interests in partnerships that trade commodities). Note that the look-through rule applicable to partnerships that trade in stocks or securities also does not extend to partnerships whose principal business is trading in stocks or securities and whose principal place of business is within the United States. Reg. section 1.864-2(c)(2)(ii). However,

(Footnote continued in next column.)

The proper treatment of the timing and character of income from ETNs for general income tax purposes is subject to debate.<sup>69</sup> Despite this ambiguity, U.S. nonresidents should be comfortable that trading in ETNs will not cause them to be treated as engaged in a trade or business within the United States. ETN issuers generally assert that their ETNs constitute one of three types of instruments for federal income tax purposes.<sup>70</sup> They maintain that most likely, their ETNs constitute forward contracts. They also state that there is a chance the IRS might assert that holders of an ETN could be treated as holding a debt instrument issued by the issuer of the ETN or that they could be treated as the beneficial owners of the ETN’s underlier.

Although this creates uncertainty for a U.S. resident investor who is unsure about the proper timing and character of income from an ETN, it should give a U.S. nonresident investor some comfort that trading in ETNs should not cause the investor to be treated as engaged in a U.S. trade or business. That is because if a VIX ETN is treated as

— this appears to be a holdover from the now-defunct rule that prevented foreign taxpayers whose principal business was trading in stocks or securities from benefiting from the stocks or securities safe harbor if their principal place of business was in the United States. Taxpayer Relief Act of 1997, P.L. 105-34, section 1162(a), striking the applicable language. An argument that outright ownership of an interest in a publicly traded partnership should constitute a derivative under prop. reg. section 1.864(b)-1(b)(2)(ii)(D) (a derivative includes any “evidence of an interest . . . in any . . . partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust”) would likely fail, both because the preamble to the proposed regulations indicates that they were intended to cover only derivative exposure and because a reading that fee ownership constitutes an “evidence of ownership in” an underlier would create significant overlap with the existing rule in section 864(b)(2) and existing reg. section 1.864-2(c)(2), (d)(1). REG-106031-98; see also Spiros Pappadopoulos, “Can an Asset Be a Derivative of Itself?” 11 *J. Tax’n Fin. Prod.* 25 (2014).

<sup>69</sup>For example, the IRS has ruled that an ETN with an underlier consisting of a stated amount of foreign currency should be treated as a foreign-currency-denominated debt instrument, and it has invited comments regarding the proper treatment of other kinds of ETNs. Rev. Rul. 2008-1, 2008-1 C.B. 248; Notice 2008-2, 2008-1 C.B. 252. Legislative proposals have been made to require holders of ETNs to accrue interest currently, and commentators have advocated different types of treatment for those instruments. See, e.g., H.R. 4912, 110th Congress (2007-2008) (introducing a new section 1289, requiring holders of prepaid forward contracts to accrue interest currently); New York State Bar Association Tax Section, “Report on Prepaid Forward Contracts” (June 26, 2008); Lee A. Sheppard, “Are Exchange-Traded Notes Too Good to Be True?” *Tax Notes*, Dec. 17, 2007, p. 1117; Sheppard, “Are Exchange-Traded Notes Too Good to Be True? Part 2,” *Tax Notes*, Mar. 17, 2008, p. 1172; and Ray Beeman and Yoram Keinan, “The Tax Treatment of Exchange-Traded Notes: Here We Go Again,” *Tax Notes*, May 5, 2008, p. 485.

<sup>70</sup>See, e.g., VXX and VXZ, *supra* note 34.

a forward contract, it should be treated as a forward contract to buy a commodity (that is, VIX futures contracts) and a security (that is, the Treasury bills whose yield makes up the interest component of the ETN). If a holder of an ETN is treated as holding the assets underlying the ETN, the holder should simply be treated as holding VIX futures contracts and Treasury bills; and if an ETN is treated as a debt instrument of the issuer, the holder thereof should simply be treated as holding a security. Although it is unclear which of the three alternative characterizations is correct, any one of them would fit within one or more of the applicable safe harbors.

### B. Publicly Traded Partnership and RIC Income

As mentioned above, some VIX ETFs maintain that they are publicly traded partnerships that are not taxed as corporations under section 7704(a), and others maintain that they qualify as RICs. Qualification as either type of entity should allow the ETFs to escape entity-level taxation.<sup>71</sup> However, qualification in both cases depends in part on whether income from VIX-referenced instruments constitutes either qualifying income of a publicly traded partnership or good RIC income. Because the definition of qualifying income incorporates by reference the definition of good RIC income, this threshold should be met in both cases if income or gain from VIX-referenced instruments constitutes good RIC income.<sup>72</sup> As discussed below, the government's reading of section 851(b)(2) in analogous contexts indicates that income or gain from VIX-referenced instruments should constitute both good RIC income and qualifying income of a publicly traded partnership.

By way of background, partnerships whose interests are traded on an established securities market or whose interests are readily tradable on a secondary market (publicly traded partnerships) are generally treated as corporations for federal income tax purposes.<sup>73</sup> However, if 90 percent or more of the publicly traded partnership's gross income consists of qualifying income, the entity is not subject to this treatment.<sup>74</sup> Qualifying income includes interest, dividends, gain from the disposition of stocks, securities or commodities, or futures, forwards, or options on commodities, or any income that would qualify as good RIC income under

the RIC rules.<sup>75</sup> Effectively, this means that if an item of income qualifies as income that may be applied toward the 90 percent gross investment income requirement applicable to RICs under section 851(b)(2), it may also be treated as qualifying income of a publicly traded partnership under section 7704(d).

The statutory regime for investment companies was first introduced in 1936.<sup>76</sup> Since then, Congress has consistently stated that the purpose of the gross income requirement is to ensure that the tax regime applicable to RICs apply only to entities that engage in passive investment activities rather than normal businesses.<sup>77</sup> A similar purpose was articulated when Congress passed the publicly traded partnership rules in 1987:

In general, the purpose of distinguishing between passive-type income and other income is to distinguish those partnerships that are engaged in activities commonly considered as essentially no more than investments, and those activities more typically conducted in corporate form that are in the nature of active business activities. In the former case, the rationale for imposing an additional corporate-level tax on investments in publicly-traded partnerships is less compelling, because purchasers of such partnership interests could in most cases independently acquire such investments. . . . Where the activity of the partnership does not fall into the category of generating passive-type income, however, it is less likely that direct interests in the activity would be available to investors; rather, it is more likely that such activities would be conducted in corporate form and would therefore be subject to corporate level tax before the profits reached the hands of investors.<sup>78</sup>

The scope of activities that fit within the "passive" category has been interpreted broadly. For example, Congress amended section 851(b)(2) in 1978 to include payments received on securities

<sup>71</sup>Partnerships are generally not subject to entity-level taxation. Section 701. RICs are subject to entity-level tax but may deduct most dividends from taxable income. Section 852(a)(1) and (b)(3)(A).

<sup>72</sup>Section 7704(d)(4).

<sup>73</sup>Section 7704(a).

<sup>74</sup>Section 7704(c).

<sup>75</sup>Section 7704(d)(1) and (4).

<sup>76</sup>Revenue Act of 1936, P.L. 74-740.

<sup>77</sup>H.R. Rep. No. 86-2020 (1960) ("Your committee . . . has taken care to draw a sharp line between passive investments and the active operation of business."); H.R. Rep. No. 94-10612 (1976) ("The purpose of [the gross income requirement] is to help ensure that the regulated investment company is essentially engaging in passive investment activities, and is not operating as a normal business.")

<sup>78</sup>H.R. Rep. No. 100-391, at 1068.

loans.<sup>79</sup> Those payments were included in the definition of good RIC income because securities lending is closely related to investment.<sup>80</sup> Gain from the writing of options was similarly treated for related reasons.<sup>81</sup> Regulations issued in 1998 to clarify the scope of qualifying investment income under section 7704(d) have also interpreted this category broadly.<sup>82</sup>

Set within the policy context described above, income or gain from VIX-referenced instruments should constitute good RIC income and qualifying publicly traded partnership income under one of two theories. First, the IRS has ruled that a second- or third-order derivative on a security constitutes a security for relevant purposes. Under section 851(b)(2), good RIC income includes dividends, interest, payments on securities loans, and gain from the sale or disposition of securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended), foreign currencies, or other income — including gain from options, futures, or forward contracts — derived from the taxpayer's business of investing in stock, securities, or currencies. Section 2(a)(36) of the 1940 act defines a security as follows:

Any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities

exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.<sup>83</sup>

The IRS, in a series of letter rulings issued during the latter half of the 1980s, addressed whether income or gain from second-order derivatives on stocks or securities can count toward the RIC gross income test.<sup>84</sup> For example, in LTR 8742045, the taxpayer was a RIC that traded in options on S&P index futures.<sup>85</sup> The IRS first examined the definition of security under the 1940 act. It then ruled that since a futures contract on an equity index could qualify as a security under the definition therein, an option on an equity futures contract should itself also be treated as a security:

A futures contract on a stock index would qualify as a security because it may be viewed as "any interest [in any group or index of securities]" or as similar to "a right to subscribe to or purchase, any of the foregoing [including a stock index]." Since a futures contract on a stock index is a security, an option on a stock index futures contract is also a security because section 80a-2(a)(36) of the Investment Company Act of 1940, as amended, defines a security to include any option on a security.<sup>86</sup>

<sup>83</sup>15 U.S.C. section 80a-2(a)(36).

<sup>84</sup>GCM 39295 (Mar. 30, 1984); GCM 39316 (Dec. 21, 1984); LTR 8726017; LTR 8721040; LTR 8742045; LTR 9012008. This guidance arose partly out of a jurisdictional dispute between the SEC and the CFTC in the early 1980s. See *Board of Trade of Chicago v. SEC*, 677 F.2d 1137 (7th Cir. 1982). See also H.R. Rep. No. 97-626, pt. 2, at 1-2 (1982); and S. Rep. No. 97-390, at 1. In the wake of this litigation, Congress amended the definition of security in both the Securities Exchange Act of 1934 and the 1940 act. The definition in the 1934 act was changed to exclude debt or equity futures options, but the definition in the 1940 act was not similarly amended. The IRS took Congress's decision not to exclude futures options from the 1940 act definition as an indication that it intended for debt and equity futures options to be treated as securities for section 851(b)(2)(A) purposes.

<sup>85</sup>S&P index futures contracts are cash-settled futures contracts that reference the S&P 500 index. Options on futures contracts are contracts that grant the holder the right, but not the obligation, to enter into a futures contract at a forward price equal to the options' strike price. For example, if a taxpayer purchases a call on an S&P futures contract with a strike price of \$2,000, if the futures contract settles at \$2,100 on the option expiration date, the holder will receive one futures contract, and his margin account will be credited as though he had entered into the futures contract when the futures price was \$2,000.

<sup>86</sup>*Id.*

<sup>79</sup>P.L. 95-345.

<sup>80</sup>S. Rep. No. 95-762 (1976). See also discussion of the treatment of payments made on securities loans as UBTI, *infra*.

<sup>81</sup>H.R. Rep. No. 94-10612 (1976).

<sup>82</sup>Reg. section 1.7704-3; T.D. 8799. These regulations clarify that (1) gain from the disposition of non-dividend-paying stock is qualifying income; (2) mark-to-market gain or gain from a constructive sale transaction recognized under section 475(f), 1256, 1259, or 1296 may be treated as qualifying income; (3) income or gain received in the course of a business of trading instruments that may give rise to qualifying income is qualifying income (although income or gain received in the course of a dealing business is not qualifying income); and (4) income from holding annuities or notional principal contracts and "other substantially similar income from ordinary and routine investments" is qualifying income to the extent determined by the commissioner.

In other words, the definition of security in this context is recursive. A share of stock, a debt instrument, or an equity index is a security. Also, any option, privilege, interest or participation in, or right to subscribe to or purchase a security (what we would call a derivative on a security) is a security. Because a derivative on a security is itself a security, a derivative on a derivative on a security is also a security. Likewise, a derivative on a derivative on a derivative on a security would be — you get the picture. Therefore, VIX futures, VIX ETNs, and interests in VIX ETFs should be treated as securities for purposes of sections 851(b)(2)(A) and 7704(d)(4). The baskets of shares that compose the S&P 500 index are securities under this definition. Options on those shares should also constitute securities. As discussed above, the VIX is an average of prices of a broad cross-section of these options, with some pricing inputs stripped away. As such, the VIX should constitute a security for these purposes because it represents an interest or a participation in these options. A futures contract, an ETN, or an ETF would in turn constitute further derivatives on securities and hence further securities.

In addition to the foregoing, the IRS has ruled in both the RIC and the publicly traded partnership contexts that income or gain from an activity that is an integral part of a taxpayer's activity of trading or investing in securities will give rise to qualifying income, even if the activity itself does not constitute trading or investing in securities. Recall that good RIC income includes gain from the disposition of securities or other income derived "with respect to" the taxpayer's business of investing in stock, securities, or currency.<sup>87</sup> Income or gain from merely speculating in a commodity will not give rise to qualifying income under either regime because a commodity is not a security.<sup>88</sup>

However, the IRS has ruled that the purchase of a commodity or the entry into a derivative contract on a commodity may give rise to good RIC income if the taxpayer gains exposure to the commodity to hedge risk associated with stocks or securities. For example, the taxpayer in LTR 200440012 entered into option and futures contracts on gold to hedge the risk of price fluctuations in its portfolio of shares of gold mining companies. After finding that the price of shares in those companies correlated closely with the price of gold, the IRS determined

that entry into positions in gold futures and options constituted an activity entered into "with respect to" the taxpayer's business of investing in gold mining companies.<sup>89</sup>

The IRS has ruled similarly regarding commodity royalty and net profit interests entered into to hedge a RIC's position in debt instruments issued by natural resource companies.<sup>90</sup> Therefore, even if the IRS were to assert that VIX-referenced instruments themselves are not stocks or securities for relevant purposes, if those instruments are used to hedge option Greeks or the risk of price changes in an equity index, income or gain from them should constitute good RIC income under section 852(b).

### C. Unrelated Business Taxable Income

Existing guidance indicates that gain from VIX-referenced instruments should not constitute UBTI. As discussed above, organizations exempt from tax under section 401(a) or 501(c) are subject to tax on their UBTI.<sup>91</sup> UBTI is gross income derived by any organization from an unrelated trade or business regularly carried on by it, less specified directly related expenses.<sup>92</sup> Under a statutory exclusion, dividends, interest, payments received on securities loans, and all gain from the disposition of inventory or property not held primarily for sale to customers are generally not treated as UBTI.<sup>93</sup>

Regulations extend this exclusion to annuities, income from notional principal contracts (as defined in reg. section 1.863-7 or 1.446-3), and other substantially similar income from ordinary and routine investments, to the extent determined by the IRS.<sup>94</sup> Note, however, that the exclusion for investment income does not include unrelated debt-financed income.<sup>95</sup> Unrelated debt-financed income is income derived from debt-financed property (as defined) multiplied by a fraction, whose numerator is the average acquisition indebtedness for the tax year incurred for the property and whose denominator is the property's adjusted basis.<sup>96</sup> Debt-financed property is property held to produce income for which there is acquisition indebtedness

<sup>89</sup>LTR 200440012. In so ruling, the IRS referred to the "substantial diminution of risk" through the holding of positions in "substantially similar or related property" in the straddle rules of section 1092(c)(2) and reg. section 1.246-5(b)(1). The IRS said that this was merely analogous authority and did not state a position regarding the application of the straddle rules to the transactions in question.

<sup>90</sup>LTR 200532032.

<sup>91</sup>Section 511(a)(1).

<sup>92</sup>Section 512(a)(1).

<sup>93</sup>Section 512(b)(1) and (5).

<sup>94</sup>Reg. section 1.512(b)-1(a)(1).

<sup>95</sup>Section 514(a).

<sup>96</sup>Section 514(a)(1).

<sup>87</sup>Section 851(b)(2).

<sup>88</sup>See, e.g., Rev. Rul. 2006-1, 2006-1 C.B. 261 (notional principal contract on commodity index entered into for purely speculative purposes does not give rise to qualifying income, even though the fixed-rate leg matches payments on a basket of debt instruments held by the taxpayer); and LTR 200635008 (similar).

at any time during the tax year.<sup>97</sup> Acquisition indebtedness is generally indebtedness incurred to acquire or improve property, or indebtedness that would not have been incurred but for the acquisition of property.<sup>98</sup> Therefore, for income of an exempt organization not to be UBTI under these rules, it must both fall within the category of good investment income and not be unrelated debt-financed income.

Although the code defines investment income in terms of a finite series of stated categories, the legislative history and regulatory guidance indicate that the scope of the rule is to be interpreted broadly to include all investment-type income. The tax on UBTI was introduced by the Revenue Act of 1950.<sup>99</sup> Congress intended for the tax to eliminate the possibility of unfair competition between businesses carried on by taxable enterprises and by EOs.<sup>100</sup> Although later legislative history and guidance cite this as support for the position that the category of good investment income should be read expansively, the House and Senate reports differ slightly. The Senate report implies that investment-type income should be excluded from UBTI per se because it is not the kind of income likely to result in unfair competition with taxable enterprises:

Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income *because your committee believes that they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income.* Moreover, investment-producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts.<sup>101</sup> [Emphasis added.]

By contrast, the House report implies that investment income should be excluded from UBTI only if it can be determined independently that the income is used for exempt purposes:

The tax applied to unrelated business income does not apply to dividends, interest, royalties (including, of course, overriding royalties), rents (other than certain rents on property acquired with borrowed funds), and gains from sales of leased property. Your committee believes that such "passive" income should not be taxed *where it is used for exempt purposes* because investments producing income of

these types have long been recognized as proper for educational and charitable organizations.<sup>102</sup> [Emphasis added.]

The Senate reading appears to have won out. For example, the IRS originally ruled that premiums collected from lapsed options constituted UBTI because they did not, under contemporary law, constitute gain from the disposition of property and therefore did not fit within one of the categories of investment income excluded from the definition of UBTI.<sup>103</sup> This was the case even though gain from the disposition of a security purchased in accordance with the exercise of an option would be excluded from UBTI as capital gain.<sup>104</sup> Congress changed this in 1976, when section 512(b)(5) was amended to provide that premiums collected upon option lapses should be treated as excludable gain.<sup>105</sup> In describing the provision, the Senate report to the bill reads as follows:

The committee believes that it is inappropriate to tax income from options which are written by exempt organizations and which lapse or are terminated as unrelated business income merely because such lapse or termination income is categorized as ordinary income. *Taxing such income is inconsistent with the generally tax-free treatment accorded to exempt organizations' income from investment activities.*<sup>106</sup> [Emphasis added.]

The committee further stated that if option premiums are collected in accordance with sales to customers in the course of a business, they should not be excluded from UBTI because in that case, the activity giving rise to the premiums would constitute a trade or business.<sup>107</sup> This is consistent with the treatment of capital gains under section 512(b)(5).<sup>108</sup>

The history of the treatment of payments received on securities loans is also significant in this regard. Securities loans generally occur in the context of short sales of securities. A short sale of a security is a transaction whereby a taxpayer (the borrower or the short seller) borrows the security from another party (the security lender) and sells it to a third party (the buyer). The short seller is required to return identical securities (although not the same securities) to the securities lender at the end of the term of the loan. As long as the short

<sup>97</sup>Section 514(b)(1).

<sup>98</sup>Section 514(c)(1).

<sup>99</sup>P.L. 81-814.

<sup>100</sup>H.R. Rep. No. 81-2319 (1950); S. Rep. No. 81-2375 (1950).

<sup>101</sup>S. Rep. No. 81-2375, at 506.

<sup>102</sup>H. Rep. 81-2319, at 409.

<sup>103</sup>Rev. Rul. 66-47, 1966-1 C.B. 149.

<sup>104</sup>*Id.*

<sup>105</sup>P.L. 94-396.

<sup>106</sup>*Id.*

<sup>107</sup>*Id.*

<sup>108</sup>*Id.*

position remains open, the short seller is required to make dividend- or interest-equivalent payments to the securities lender equal to any distributions or interest paid on the security. Also, the short seller is required to compensate the securities lender for the use of the securities. This is typically done through the use of a rebate on collateral interest. When the short seller borrows securities from the securities lender, the short seller is usually required to post collateral consisting of either cash or other securities. The securities lender is required to pay any interest owed on the collateral back to the short seller, less a rebate that represents compensation for the use of the securities. When the rebate is greater than interest paid on the collateral, the short seller is required to pay the securities lender a borrow fee for the same purpose.<sup>109</sup> For general federal income tax purposes, a securities loan is treated as a disposition of the lent security by the lender. Once the transaction is completed, the lender's legal rights morph from a fee interest in the lent asset to a contractual claim against the borrower for a return of substantially similar property.<sup>110</sup> Because of this, subject to some exceptions, dividend- or interest-equivalent payments made on a securities loan do not themselves constitute dividends or interest.<sup>111</sup>

In light of the foregoing, the IRS first maintained that income from securities lending transactions should not fall within the investment income exception to UBTI. In GCM 36948, the IRS asserted that because interest- and dividend-equivalent payments and borrow fees do not fall into one of the excluded categories, income earned by an exempt organization attributable to payments of these types

<sup>109</sup>For a thorough discussion of the tax consequences of securities loans, see Michael Feder, "Securities Lending Transactions: Tax Considerations in Domestic and Cross-Border Transactions," 3 *J. Tax'n Fin. Prod.* 11 (2002).

<sup>110</sup>*Provost v. United States*, 269 U.S. 443 (1926) ("For the incidents of ownership, the lender has substituted the personal obligation, wholly contractual, for the borrower to restore him, on demand, to the economic position in which he would have been, as owner of the stock, had the loan transaction not been entered into."). See also *Richardson v. Commissioner*, 121 F.2d 1 (2d Cir. 1941) (short position not closed out until shares actually delivered to close it out; since the lender did not own the underlying shares while the loan was outstanding, gain or loss from the transaction could not be computed until shares were delivered).

<sup>111</sup>See, e.g., prop. reg. section 1.1058-1(d) (dividend- or interest-equivalent payments are treated as a fee for the use of property rather than dividends or interests). This rule is overridden under some circumscribed look-through rules, including section 871(m)(2)(A) (dividend-equivalent payments made by stock borrower on shares of a U.S. issuer are treated as U.S.-source dividends for purposes of section 871(a)) and reg. section 1.861-2(a)(7), -3(a)(6) (sourcing of substitute interest payments and substitute dividend payments made on securities lending transactions, respectively).

should be treated as UBTI.<sup>112</sup> Responding to comments both from industry and from within the government, the IRS reversed this position in GCM 37313:

Our conclusions in G.C.M. 36948 were the subject of a conference held on June 22, 1977, at which it was decided to re-examine the question whether securities "lending" activities should be considered "trade or business" within the meaning of section 513. It appeared that subjecting income derived from such activities of exempt organizations to tax was inconsistent with the general intention of the Congress not to tax investment activities of exempt organizations.

In the proposed ruling we have relied upon recent Congressional action with respect to the income derived by exempt organizations from lapsed options to support our conclusion that securities transactions of such organizations are not trade or business. Pub. L. 94-396, 94th Cong., 2d Sess. (1976) amended section 512(b)(5) of the Code to exclude income from lapsed options from the computation of unrelated business income tax. The report of the Senate Committee on Finance makes it clear that Congress thought it inappropriate to tax the income derived by exempt organizations in their securities transactions. S. Rep. No. 94-1172, 94th Cong., 2d Sess. 3, 4 (1976). In addition, the committee report suggests that an exempt organization's dealings with its securities portfolio should not be considered trade or business unless the organization is holding securities in inventory or for sale to customers in the ordinary course of business.

This result is also supported by the legislative history of the Revenue Act of 1950, which added the unrelated business income provisions to the Internal Revenue Code of 1939. As with the more recent legislation, the committee reports to the 1950 Act make it clear that Congress did not intend the tax to apply to the income derived by exempt organizations from their investment activities. See S. Rep. No. 2375, 81st Cong., 2d Sess. (1950), 1950-2 C.B. 483, 506. Although it could be argued that Congress intended to reach this result by excluding certain types of income in what is now section 512(b), it is apparent that the courts would be hesitant to uphold imposition of the unrelated business income tax on a type of income the Congress intended to be tax free.

<sup>112</sup>GCM 36948 (Dec. 10, 1976).



For these reasons, we believe that the Service should accept the proposition that securities transactions of section 501(a) organizations are not trade or business unless the organizations are brokers or dealers in securities.<sup>113</sup>

In other words, even though income from securities lending transactions did not fall into one of the statutory pigeonholes for categories of excluded investment income, the IRS maintained that it should be treated as excluded investment income because there was a clear congressional intent to exclude all investment income not connected with a trade or business. The IRS implemented this position with a revenue ruling in 1978,<sup>114</sup> and Congress amended section 512(b)(1) to explicitly exclude payments on security loans from UBTI in the same year.<sup>115</sup>

The IRS has also examined whether gain or loss from futures contracts should be treated as UBTI.<sup>116</sup> The guidance issued on this point is consistent with the foregoing, but it also takes the analysis a step further. In a general counsel memorandum and a series of letter rulings, the IRS has maintained that gain from futures contracts on stocks and commodities should not constitute UBTI because it is gain from the disposition of capital assets that are not debt-financed property.<sup>117</sup> To reach this conclusion, the IRS noted that gain or loss from the termination of a futures contract is not gain or loss from the disposition of the underlier; instead, it is gain or loss from the disposition of the futures contract itself, which constitutes an asset independent of the underlier.<sup>118</sup> The IRS reasoned that if taxpayers do not borrow money to enter into these contracts and are not in the business of offering them to customers, gain therefrom should be gain from the disposition of non-debt-financed capital assets. It observed that, although a taxpayer who purchases securities on margin clearly incurs acquisition indebtedness for them, because a futures margin account is merely a performance bond, entry into a futures contract should not be treated as the acquisition of debt-financed property. The IRS also noted that in the alternative, since a taxpayer does not pay to enter into a futures contract, the taxpayer has a zero basis therein. Therefore, it determined, even if

a taxpayer were to incur acquisition indebtedness for a futures contract, the amount of UBTI resulting therefrom would be zero.<sup>119</sup>

The foregoing is good news for EOs looking to invest in VIX-referenced instruments. The treatment of gain or loss from VIX futures contracts should not differ materially from that of gain or loss from futures contracts on stocks or commodities. Because a VIX futures contract constitutes an asset separate from the underlier, gain from the disposition thereof by an EO that does not enter into transactions with customers should constitute gain from the disposition of a non-inventoried capital asset. The rulings that discussed the treatment of futures contracts in the context of UBTI did not address the treatment of forward contracts; however, it should not differ materially from that of a futures contract. As discussed above, the only difference between a futures contract and a forward contract is that a futures contract is “intermediated” by an exchange. Economically, the two types of instruments are identical.

Therefore, if a VIX ETN is treated as a forward contract, gain or loss therefrom should be treated as gain or loss from the disposition of a capital asset.<sup>120</sup> If a VIX ETN is treated as a debt instrument or as a custodial arrangement, gain from the disposition thereof should be treated as gain from either the disposition of a debt instrument or the disposition of a futures contract, respectively. Gain from the disposition of shares in a VIX ETF that is treated as a corporation should be treated simply as gain from the disposition of shares of stock; and an EO’s distributive share of income from a VIX ETF treated as a partnership should be excluded from UBTI to the extent that it would be excluded from UBTI were it received directly by the EO.<sup>121</sup>

<sup>119</sup>See, e.g., LTR 8717066 (“If we were to treat the borrowing for the margin deposit required in purchasing a long futures contract as acquisition indebtedness, the debt/basis percentage computation required under section 514(a) would not be meaningful. The futures contract has no basis prior to its performance. See Rev. Rul. 57-29, 1957-1 C.B. 519. In determining the debt/basis percentage, the denominator of the fraction involved would be zero.”). There is a question whether the IRS meant numerator rather than denominator. Section 514(a)(1) (UBTI from debt-financed property is the same “as (A) the average acquisition indebtedness . . . for the taxable year with respect to the property is of . . . (B) the average amount . . . of the adjusted basis of such property during the period it is held by the organization during such taxable year”). Division of zero results in zero; division by zero results in an infinite number.

<sup>120</sup>Note, however, that because ETNs are prepaid instruments, a taxpayer will not have a zero basis in an ETN. Therefore, if a taxpayer incurs acquisition indebtedness for an ETN, all or a portion of the gain therefrom will be UBTI. Sections 514(a)(1) and 1012(a).

<sup>121</sup>Reg. section 1.512(c)-1.

<sup>113</sup>GCM 37313 (Nov. 7, 1977). See Rev. Rul. 78-88, 1978-1 C.B. 163.

<sup>114</sup>Rev. Rul. 78-88, 1978-1 C.B. 163.

<sup>115</sup>P.L. 95-345.

<sup>116</sup>GCM 39620 (Apr. 13, 1987); LTR 8717066; LTR 8708031; LTR 8110164; LTR 8107114; LTR 8104098; LTR 8044023.

<sup>117</sup>See guidance referenced *supra* note 116.

<sup>118</sup>GCM 39620 (“The contracts are themselves property, albeit property that is intangible and distinct from the underlying commodities.”).

## V. Suggested Regulatory Guidance

New guidance to the following effect would provide legal certainty to capital market participants.

### A. Effectively Connected Income

As discussed above, VIX futures should be treated both as commodities for purposes of the commodities safe harbor and as derivatives for purposes of the derivatives safe harbor, and all VIX-referenced instruments should be treated as derivatives on securities for purposes of the derivatives safe harbor. New guidance directly on this point would clarify that.

### B. RICs and Publicly Traded Partnerships

As discussed above, the IRS has time and again asserted that derivatives on stocks or securities themselves constitute stocks or securities for purposes of section 851(b)(2), even if they are several layers deep. This is consistent with the policy goal of including all income or gain from passive-investment-type activities within the scope of the rule. Futures and options on the VIX are available through most retail securities or futures brokers, and the amount of business activity required to take a position therein is no greater than that needed to buy or sell a share of stock. Guidance directly addressing the treatment of VIX-referenced instruments in this regard would allow issuers of VIX ETFs and holders of interests therein to rely on the ETFs' qualification as applicable passthrough entities.

### C. Unrelated Business Taxable Income

While existing law should make clear that income and gain from VIX-related products should be excluded from EOs' UBTI calculation, the issuance of new guidance directly on point would remove any vestigial ambiguity regarding this issue.

## IN THE WORKS

A look ahead to planned commentary and analysis.

### Unclaimed property insight — Extension of Delaware's friendlier voluntary disclosure program (*State Tax Notes*)

Joseph Carr discusses unclaimed property changes in Delaware designed to make the voluntary disclosure process friendlier for holders.

### Stock sales treated as asset sales: SALT aspects (*State Tax Notes*)

Peter Faber discusses the particulars of a section 338 election.

### Is an insurance premium FDAP? (*Tax Notes*)

Stuart Katz analyzes how the D.C. Circuit's opinion in *Validus* affects whether insurance premiums are subject to withholding tax.

### Who's afraid of reg. section 1.267(b)-1(b)? (*Tax Notes*)

Annie Jeong summarizes the loss disallowance rules applicable to partnerships and argues that entity theory, as opposed to an aggregate approach, applies to partnerships in that context.

### Russia's 2015 tax revolution (*Tax Notes International*)

Olga Boltenko, Evgenia Martin, and Ayshat Gaydarova discuss Russia's recent changes to its offshore tax laws, which will affect international structures used to avoid Russian taxation.

### Holding Treasury to its word: *Altera* and capricious regulations (*Tax Notes and Tax Notes International*)

Jasper L. Cummings, Jr., discusses how Treasury can defend regulations in the wake of the Tax Court's decision in *Altera*.