

Client Alert.

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No-Action Relief Excludes Tax Blocker Entity from Definition of Investment Company

By Jay G. Baris and Kelley A. Howes

On August 30, 2012, the SEC's Division of Investment Management said that it would not recommend enforcement action if an oil and natural gas company implementing an alternative capital structure did not register as an investment company.

LINN Energy, LLC ("LINN") created a structure to enable tax-exempt and foreign entities to invest indirectly in LINN through a wholly-owned subsidiary, LinnCo, LLC ("LinnCo"), thus providing more favorable tax treatment than with a direct investment. LinnCo, however, may be an investment company as defined in sections 3(a)(1)(A) and 3(a)(1)(C) of the 1940 Act, because its sole assets will consist of investment securities, that is, interests in LINN, and cash.

Typically, third parties can rely on guidance the staff provides in no-action letters. Here the staff stated that no one else can rely on this guidance because it relates only to the unique facts in this case, described below.

Units representing interests of LINN are listed on the NASDAQ Global Select Market ("NASDAQ"). LINN is treated as a partnership for U.S. tax purposes: its income and deductions are allocated to holders of its units. LinnCo will be treated as a corporation for U.S. tax purposes and its shares will also be listed on NASDAQ.

LinnCo was established as an additional means to raise capital in the public equity markets to finance LINN's oil and gas property acquisition strategy by selling LinnCo's common shares to the public. LinnCo will use the sale proceeds to purchase an equal number of newly issued LINN units. LinnCo will conduct no activity other than owning LINN units and distributing the cash it receives from its ownership of the units (net of reserves for income taxes payable) to LinnCo shareholders.

Subsequent to its initial public offering, LinnCo will own at least 13% of LINN units outstanding. Those units, together with cash and cash equivalents, will be the only holdings of LinnCo. Accordingly, LinnCo could be deemed to be an investment company as defined in sections 3(a)(1)(A) or 3(a)(1)(C) of the 1940 Act.

Since LinnCo is established solely as a means for certain types of investors to invest in LINN units in a tax favorable structure, however, LinnCo argued that it does not raise the concerns underlying the 1940 Act, and is not the type of entity that should be governed by the 1940 Act. The Division gave its assurance that it would not recommend enforcement action to the Commission under Section 7(a) of the 1940 Act.

In its no-action letter, the Division noted the governance provisions adopted by LinnCo, which, among other things, limit LinnCo's ability to engage in any activities other than investing as discussed above; require LinnCo to maintain a one-to-one relationship between the number of LINN units it owns and the number of LinnCo shares outstanding; and require LinnCo to vote the units in such a way as to effectively give each LinnCo shareholder the same voting power with respect to LINN as if the shareholder directly owned LINN units.

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The Division also noted that LINN agreed to provide LinnCo with certain services, and to bear certain costs. As a result, LinnCo shareholders will be in the same position with respect to governance and economics, other than with respect to taxes, of LINN as direct holders of LINN units. Finally, the Division noted that LinnCo will not hold itself out as being engaged in the business of investing, reinvesting, or trading in securities, and will not acquire any investment securities except units of LINN, and cash or cash equivalents. Under these circumstances, the Division agreed not to recommend enforcement action against LINN or LinnCo.

While this letter provides some insight into how the Division might analyze the question of whether or not an entity is an investment company as defined in the 1940 Act, it does not provide any specific certainty for other similarly situated entities, each of which would have to seek specific no-action relief.

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