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United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

December 20, 2011

VIA U.S. MAIL & EMAIL (Floyd.Williams@IRS.gov)

The Honorable Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

**RE: Private Letter Rulings to Mutual Funds
Seeking Commodities Exposure**

Dear Commissioner Shulman:

Since 2006, the Internal Revenue Service (IRS) has issued over 70 private letter rulings allowing mutual funds that operate as regulated investment companies for U.S. federal income tax purposes to make unlimited indirect investments in commodities through controlled foreign subsidiaries or commodity-linked notes, despite Internal Revenue Code Section 851(b)(2) which requires such funds to derive 90% of their income from securities and no more than 10% from other sources, including commodities. We support the recent decision of the IRS to suspend issuance of new letters in this area to review the underlying policy issues. Pending the results of that review, we believe it may be appropriate to permanently suspend all future private letter rulings in this area and reevaluate the tax treatment of all mutual funds currently allowed to treat indirect commodity investments as income derived from "securities" under Section 851.

**Speculation in U.S. Commodity Markets.** Since 2002, the U.S. Senate Permanent Subcommittee on Investigations has conducted a series of investigations into commodity prices, focusing on how excessive speculation in the futures and swaps markets may have affected commodity prices, normal supply and demand factors, and American consumers and businesses.[1] Commodity markets enable producers and users of physical commodities to arrive at a fair price for their goods and hedge their price risks over time. Speculators can make a positive contribution to commodity markets by facilitating price discovery and hedging activities. In recent years, however, evidence indicates that speculators have come to invest heavily in many commodity markets and may have contributed to distorted prices, price volatility, and hedging failures. In response, Congress has enacted a series of legislative acts to reduce excessive speculation in the commodity markets.[2]

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[1] See, e.g,, "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat," S. Prt. 109-65 (June 27, 2006); "Excessive Speculation in the Natural Gas Market," S. Hrg. 110-235 (June 25 and July 9, 2007), "Excessive Speculation in the Wheat Market," S. Hrg. 110-235 (June 25 and July 9, 2007); and "Excessive Speculation and Compliance with the Dodd-Frank Act," (November 3, 2011).

[2] See, e.g., CFTC Reauthorization Act of 2008, P.L. 110-246; Sections 727 and 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L 111-203.

For most of the 70 years they have been in existence, mutual funds were not significant participants in U.S. commodity markets. After the IRS began issuing private letter rulings in 2006, allowing them to engage in a variety of indirect commodity investments, however, mutual funds have poured billions of speculative dollars into commodity investments. Allowing mutual funds nearly unfettered access to commodity markets through these letter rulings appears to be contrary to Congressional intent and allows mutual funds to get around otherwise clear restrictions on their commodity investments.

**Section 851's Income Source Restrictions.** Mutual funds operate under a dual set of statutory restrictions, those provided by the Internal Revenue Code (IRC), which is enforced by the IRS, and those provided by the Investment Company Act of 1940 (1940 Act), which is overseen by the Securities and Exchange Commission (SEC). The tax provisions essentially restrict the types of income that mutual funds are allowed to claim in exchange for favorable tax treatment.[3] The income source restrictions are contained in Section 851(b)(2), which requires that 90% of a mutual funds' gross income must be derived from equities, securities, or currencies, and not more than 10% from alternatives like commodities.

Section 851(b)(2) defines the qualifying income in relevant part to include:

> "dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies."[4]

A "security" is defined under the 1940 Act 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."[5]

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[3] Under the tax code, mutual funds that comply with the relevant tax provisions are not subjected to any taxation at the corporate level. Instead, all of the mutual fund's income is attributed to its shareholders who are then subject to tax on an individual basis. See IRC Subchapter M.

[4] IRC Section 851(b)(2).

[5] Investment Company Act of 1940, Section 2(a)(36).

Neither Section 851 nor the 1940 Act definition allows mutual funds to derive more than 10% of their income from commodities, whether through futures, forward contracts, options, swaps, notes, or other commodity-related products.

**Significant Increase in Commodity Investment.** To date, the IRS has issued 72 private letter rulings allowing mutual funds to treat income from investments in certain commodity linked notes or through controlled foreign corporations (CFCs) that invest in commodities as qualified income under Section 851(b)(2).[6] The letters hold that distributions from the commodity linked notes and dividends from the commodity-related CFCs can be treated as income derived from securities, rather than income derived from commodities, and thus, meet the income source restrictions in Section 851(b)(2). By treating this income as derived from securities rather than commodities, the IRS has enabled mutual funds to do indirectly what they are prohibited by law from doing directly.

Since 2006, the IRS private letter rulings have opened the floodgates for the $11 trillion mutual fund industry to make sizeable investments in the commodity markets. In a recent hearing, the Subcommittee identified at least 40 commodity related mutual funds with accumulated assets in excess of $50 billion.[7] These funds have all set up offshore wholly-owned CFCs that exist solely to trade commodities in the futures and swaps markets. The mutual funds typically organize their CFCs as Cayman Island subsidiaries; operate them as shell entities with no physical offices or employees of their own; and run the CFCs' commodity portfolios from their U.S. offices. That the Cayman CFCs are empty shells designed to allow U.S. mutual funds to create commodity related investment portfolios, run by their own U.S. employees, is openly acknowledged.

The sales materials of these mutual funds show they are marketing their funds to average investors as commodity funds and using their CFCs to delve into a wide array of commodity investments, from swaps to exchange traded notes to futures. The 40 mutual funds identified by the Subcommittee generally invest 25% of their total assets in their Cayman subsidiaries and often use U.S.-based assets as collateral or margin to secure the commodity investments being made by their CFCs in the futures and swap markets. In many instances, the mutual funds provide aggregate exposure to commodities as if 100% of the fund's net assets were invested in commodity related investments. Some mutual funds offer investors leveraged exposure to their commodity related investments. One mutual fund identified by the Subcommittee reported having over $22 billion invested in commodity related assets with approximately 900,000 investors, 75% of which are individuals.[8]

The IRS private letter rulings hold that when a mutual fund forms an offshore shell corporation, holds 100% of its stock, and then uses that CFC to invest in commodities, the mutual fund may treat this activity as an investment in the stock of the CFC and not as an investment in commodities. But the CFC is not an independent business; it is a shell corporation under the mutual fund's control. The mutual fund's investment in its CFC amounts to a paper exercise to permit the mutual fund itself to make commodity investments.

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[6] See "Excessive Speculation and Compliance with the Dodd-Frank Act," hearing before the U.S. Senate Permanent Subcommittee on Investigations (November 3, 2011) (hereinafter "Subcommittee Hearing"), Exhibit 7d.
[7] Subcommittee Hearing Exhibit 7a.
[8] Id., materials related to PIMCO Commodity Real Return Strategy Fund.

Some may contend that a 1943 Supreme Court case known as Moline Properties requires the IRS to recognize corporate structures such as the CFCs set up by mutual funds to invest in commodities.[9] But Moline Properties itself states:

> "In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction. Higgins v. Smith, 308 U.S. 473, 477, 478 S., 60 S.Ct. 355, 357, 358; Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 97 A.L.R. 1355."[10]

Mutual fund CFCs set up to invest in commodities are exactly the type of sham entities designed to perform a "bald and mischievous fiction" -- circumventing longstanding statutory income source restrictions -- that Moline Properties permits the IRS to disregard. That Supreme Court precedent, thus, does not require nor countenance the IRS' validating a corporate fiction or facilitating an end-run around the income source restrictions on mutual funds.

In addition to allowing mutual funds to use offshore shell entities to invest in commodities, IRS private letter rulings have permitted mutual funds to use commodity-linked notes to do the same. The private letters allow mutual funds to treat these notes as "securities" and deem the construction, funding, and sale of interests in those notes as securities investments, despite the fact that the notes are designed for the purpose of investing in commodities. This approach contradicts an earlier IRS Revenue Ruling which held that Congress did not intend to allow "an expansive construction of the term 'securities'" to enable mutual funds to invest in commodities.[11] In addition, the private letter rulings fail to take into account Congressional codification of the economic substance doctrine which permits the IRS to look through transactions that have no purpose other than tax avoidance.[12] In the private letter rulings issued by the IRS, the mutual funds offer no business purpose for creating offshore CFCs or constructing commodity-linked notes to make their commodity investments other than to characterize the resulting income as derived from "securities" and so retain their favored tax status while making unlimited commodity investments.[13] The IRS does not seem to recognize the mutual funds' commodity-linked notes and offshore CFCs for what they are – transactions with no purpose other than a tax purpose -- to enable mutual funds to circumvent the income source restrictions in Section 851(b)(2).

It is the Subcommittee's understanding that, before proceeding with their activities, each of the 40 commodity related mutual funds identified in the Subcommittee hearing obtained a private letter ruling from the IRS explicitly allowing it to treat any income from its commodity investments as security-based income under Section 851.[14] The IRS private letter rulings, thus,

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[9] Moline Properties v. Commissioner of Internal Revenue, 319 U.S. 436 (1943).
[10] Id.
[11] See Rev. Rul. 2006-1, at 5.
[12] See Health Care and Education Reconciliation Act, P.L. 111-52, Section 1409, codified at IRC Section 7701(o).
[13] See, e.g., "IRS Implicitly Rules on Economic Substance Doctrine and Blockers," by David H. Shapiro and Jeffrey W. Maddrey, Tax Notes, 1461, 1462-63 (March 21, 2011)("[N]o mention is made of a business purpose in any of the rulings ... and it is hard to imagine that there could be a nontax purpose outweighing the tax purpose on the facts of the rulings").
[14] Each mutual fund needed to obtain its own ruling, because a taxpayer may not rely on a private letter ruling provided to another taxpayer. See IRC Section 6110(k)(3) and Section 11.02 of Revenue Procedure 2011-1.

contributed to the decision of those mutual funds to make speculative investments in commodity markets. Representatives of the mutual fund industry have told the Subcommittee that the industry intends to seek additional private letter rulings to further expand its investments in commodity-related products.

**Conflicting with Congressional Intent on Commodities.** Deeming commodity linked notes and commodity related offshore shell CFCs to be investments in securities rather than in commodities appears to conflict with Congressional intent and enable mutual funds to get around the otherwise clear restrictions of Section 851(b)(2) on their commodity investments.

When federal tax provisions for mutual funds were first enacted in 1936, Congress excluded commodities from the sources of qualifying income.[15] Income sources at that time were limited to dividends, interest, and gains from the sale or other disposition of stock or securities. Congress enacted the first federal law to control excessive speculation in commodity markets that same year.[16] Despite its work on the issue, Congress made no mention of commodities as an allowable investment for mutual funds in 1936. Instead, mutual funds were designed to provide a mechanism for investors of modest means to gain exposure to the securities markets.[17]

In 1954, when Congress enacted Subchapter M of the Internal Revenue Code reforming the taxation of mutual funds, Congress again expressed its intent to limit the sources of income that mutual funds could claim in exchange for favorable tax treatment. Subchapter M again limited the sources of qualifying income to income derived from dividends, interest, and gains from the sale or other disposition of stock or securities. As in 1936, Congress was clearly aware of the existence of commodity markets, but did not list commodity investments in the statute as one of the types of qualifying income.

In 1986, Congress expanded the list of sources of qualifying income under Section 851(b)(2), but for the third time, excluded investments in commodities.[18] The 1986 amendment provided an explicit list of additional sources of income that mutual funds could claim, adding "foreign currency, and other income (including but not limited to gains from options or futures contracts) derived with respect to its business of investing in such stock, securities, or currencies." Congress could have expanded the list further to include commodities, but chose not to do so.[19] Indeed, as the IRS noted in its Rev. Rule 2006-1 holding that a derivative contract referencing a commodity index was not a securities for purposes of Section 851, Congress did not intend "an expansive construction of the term 'securities.'"[20]

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[15] "The Federal income tax provisions applicable to mutual funds were first enacted in 1936. The basic structure of and principle of these provisions, which are found in subchapter M of the Internal Revenue Code, have remained unchanged." 132 Cong. Rec. 4045, 1986 (Remarks of Senator Armstrong)(March 7, 1986). In 1936, mutual funds were referred to as mutual investment companies.
[16] See the Commodity Exchange Act of 1936, P.L. 74-765.
[17] See 132 Cong. Rec. 4046 (Remarks of Senator Armstrong)(March 7, 1986).
[18] See Tax Reform Act of 1986, P.L. 99-514.
[19] See letter from Acting Assistant Secretary of the Treasury (Tax Policy) J. Roger Mentz, dated February 5, 1986, inserted into the Congressional Record by Senator Armstrong, at 132 Cong. Rec. 4046. Mr. Mentz's letter stated that Treasury would generally not treat as qualifying income gains from trading in commodities, even if the purpose of that trading was to hedge a related stock investment.
[20] Rev. Rul. 2006-1, at 5.

In 2010, Congress reaffirmed its intent to exclude commodities from the qualifying income of mutual funds when it enacted a bill to modernize statutory provisions affecting mutual funds, the Regulated Investment Company Modernization Act, P.L. 111-325. As originally introduced in 2009, and as passed by the House in 2010, Section 201(a) of that Act, then designated H.R. 4337, would have explicitly permitted mutual funds to invest in "commodities" under Section 851(b)(2). Several Senators expressed concern that allowing the $11 trillion mutual fund industry unrestricted commodity investments would exacerbate excessive speculation in the commodity markets and objected to the provision. In response, the provision was removed from the bill which was then approved by the Senate. Removal of the commodities provision was, in fact, the only change made in the House-passed bill. The House then agreed to the bill as amended by the Senate, enacting it into law while reaffirming Congressional intent to exclude commodities from the qualifying income for mutual funds.

Despite Congress' intent to limit mutual fund investment in commodities, the IRS has used its administrative authority to permit such investments. The resulting private letter rulings have unleashed a flood of speculative commodity investments that may have contributed to excessive speculation. The IRS should not use its private letter authority to enable mutual funds to do indirectly what the law does not permit them to do directly.

**Requested Relief.** This letter urges the IRS to take immediate action to permanently halt the further issuance of private letter rulings that allow mutual funds to circumvent the income source restrictions in IRC 851(b)(2) and make unlimited indirect investments in commodities. In addition, the IRS should reevaluate the tax treatment of all mutual funds currently allowed to treat indirect commodity investments as income derived from "securities" under Section 851.

Thank you for your consideration.

Sincerely,

Tom Coburn, MD
Ranking Minority Member
Permanent Subcommittee on Investigations

Carl Levin
Chairman
Permanent Subcommittee on Investigations

cc: The Honorable Tim Geithner, Secretary of the Treasury
Emily McMahon, Acting Assistant Treasury Secretary (Tax Policy)