PRESS RELEASE

U. S. Senate Permanent Subcommittee on Investigations

HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS COMMITTEE

Carl Levin, Chairman
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FOR IMMEDIATE RELEASE
January 25, 2012
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SENATE HEARING ON IRS ACTIONS ALLOWING MUTUAL FUNDS TO SKIRT TAX LIMITS ON COMMODITY INVESTMENTS

WASHINGTON – The Senate Permanent Subcommittee on Investigations will hold a hearing Thursday exploring decisions by the Internal Revenue Service (IRS) that have increased commodity speculation by allowing some mutual funds to use offshore shell corporations and complex financial instruments to circumvent longstanding tax code limits on mutual fund trading in commodities.

"Over the last six years, in private letter rulings responding to mutual fund petitions, the IRS has opened the floodgates to ever-increasing levels of commodity speculation by the $11 trillion mutual fund industry, despite tax laws that put limits on commodity investments by mutual funds," said Levin. "Excessive speculation hurts American families who pay inflated prices for gasoline and heating oil, American businesses that face uncertainty about the cost of raw materials, and American farmers trying to sell their crops at a fair price. The effect of IRS actions allowing mutual funds to use offshore schemes and financial engineering to get around the tax law is more commodity speculation. The current moratorium halting additional private letter rulings in this area should be made permanent."

For 70 years, mutual funds have enjoyed preferential tax treatment. The tax code provides in part that, so long as mutual funds derive 90% of their income from interest, securities, or foreign currency investments, and no more than 10% from alternatives such as commodities, they do not have to pay the corporate income taxes that apply to other corporations. Instead, mutual funds pass on their profits to their investors who are then responsible for paying any taxes due. This preferential tax treatment is worth billions of dollars per year to the mutual fund industry.

Despite the tax code restrictions, the mutual fund industry began petitioning the IRS to approve various gimmicks allowing them to make increased investments in commodities without losing their preferential tax status. In response, beginning in 2006, in a series of 72 private rulings, the IRS agreed to two methods that allow mutual funds to maintain their favorable tax status while making heavy investments in commodity markets. Both enable mutual funds to make indirect commodity investments that the tax law would bar them from making directly.

One method allows a mutual fund to set up an offshore corporation, use it to invest in commodities, and then treat the resulting income – not as income from commodities – but as

from an investment in the stock of the offshore corporation that the mutual fund set up. Mutual funds have used this method to make commodity investments through offshore shell corporations that have no employees, no physical offices, and no obvious nontax purpose for their operations. The second method allows mutual funds to use complex financial instruments called "commodity linked notes," which mutual funds use essentially to contract with a third party, such as a bank, to act as their agent to invest in commodities.

Mutual funds have used both methods to make increasingly large commodity investments, including through 40 offshore commodity-related offshore shell corporations with an accumulated total of $50 billion in assets.

Thursday's hearing builds on a Subcommittee hearing in November that examined the growing influence of speculators in commodities markets. Evidence presented at that hearing shows that speculators play an increasingly large role in the markets, and that excessive speculation can harm American families and businesses by increasing price volatility, overriding normal supply and demand factors, making price hedging more difficult, and in some cases driving up commodity prices.

"In November, CFTC Chairman Gensler told us that speculators already dominate many commodity markets, including holding over 80% of the outstanding futures contracts for oil," Levin said. "That level of speculation means speculators are increasingly calling the tune on commodity prices, instead of normal market forces of supply and demand. The threat of increased oil and other commodity prices deepens when the IRS upends longstanding tax restrictions and opens the markets to a new tidal wave of commodity speculation by mutual funds."

In June 2011, the IRS suspended issuance of private letter rulings in this area pending a review of the policy issues. In December 2011, Levin and Subcommittee Ranking Member Sen. Tom Coburn sent a joint letter to the IRS urging it "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" and to "reevaluate the tax treatment of all mutual funds currently allowed to treat indirect commodity investments as income derived from 'securities' under Section 851."

The hearing will examine those policy issues, including the impact of the 2010 Regulated Investment Company Modernization Act in which, before enacting the bill into law, the Senate eliminated a provision that otherwise would have allowed mutual funds to make unrestricted commodity investments.

Thursday's hearing will include testimony from IRS Commissioner Douglas Shulman and Treasury Acting Assistant Secretary for Tax Policy Emily McMahon.

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