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HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS COMMITTEE
Carl Levin, Chairman

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# Opening Statement of Senator Carl Levin U.S. Senate Permanent Subcommittee on Investigations Hearing on Compliance with Tax Limits on Mutual Fund Commodity Speculation

For 10 years now, this Subcommittee has focused attention on the problem of excessive speculation in the commodity markets including the crude oil, natural gas, and wheat markets. Most recently, in last November's hearing, we examined efforts to apply a new position limits rule to protect consumers, businesses, and the commodity markets themselves from excessive speculation. For years now, the American people have been whipsawed by unpredictable and often escalating commodity prices. We've been hurt at the pump, we've been hurt at the dinner table, and we've been hurt in our pocket books. We're talking about gasoline prices, electricity and heating costs, food prices, and industrial raw materials that together affect virtually every American family and business budget.

The fundamental purpose of commodity markets, unlike stock markets, is not to attract investors, but to enable producers and users of physical commodities to arrive at a fair price for their goods and hedge their price risks over time. Speculators – who don't intend to use or deliver the commodities they trade or hedge commodity prices so they can have price certainty -- seek instead to profit from the price changes. A market which was intended to facilitate price discovery and hedging is now dominated by speculators who are driving up price volatility, hedging failures, and in many cases, commodity prices. The reality today is that commodity prices are more reflective of trading by speculators than fundamental forces of supply and demand.

At our November hearing, for example, the Commodity Futures Trading Commission (CFTC) told us that 80% of the outstanding futures contracts for crude oil are now held by speculators. CFTC Commissioner Bart Chilton has said:

> "For those who say no evidence exists linking excessive speculation and prices, they just aren't looking. … Scores of studies and papers exist which document the linkage."

The unprecedented flood of speculative money in commodity markets today comes from index traders, hedge funds, money managers, and exchange traded products. Our November hearing also exposed a new wave of commodity speculation coming from the $11 trillion mutual fund industry. Exhibit 1 is a chart which shows that, since 2008, more than 40 commodity related mutual funds have begun pouring speculative funds into the commodities markets and now have accumulated assets of over $50 billion.

**Opening the Floodgates.** For most of the 70 years they have been in existence, mutual funds were not significant participants in U.S. commodity markets. Now, some mutual funds have become major commodity speculators, and more want to follow. When we looked into what changed, we discovered that six years ago, mutual funds began petitioning for and receiving IRS private letter rulings that, for the first time, enabled them to invest heavily in commodities, despite longstanding restrictions in Section 851(b)(2) of the Internal Revenue Code. Those IRS private letter rulings essentially opened the floodgates to the mutual fund petitioners, allowing them to engage in billions of dollars in commodity speculation.

**Section 851.** Section 851(b)(2), which has been in the tax code since mutual funds got started in the 1930s, restricts the types of income that mutual funds are allowed to obtain in exchange for favorable tax treatment. If the mutual funds abide by this section's income source restrictions, those mutual funds do not have to pay corporate income taxes like other corporations. This tax break collectively saves the mutual fund industry billions of dollars each year. In simple terms, the statute requires that 90% of a mutual fund's gross income must be derived from securities, interest, or foreign currency investments. That means not more than 10% of their income can come from alternatives like commodities.

This 90% rule has been in place for decades. But in 2006, as financial engineering took hold of Wall Street, the mutual fund industry began pressing the IRS to permit it to use complex financial transactions that would, in essence, enable mutual funds to get around the 90% rule and engage in commodity investments beyond the 10% limit. Dozens of individual mutual funds made these requests in petitions for private letter rulings.

In response, from 2006 to 2010, the IRS issued 72 private letter rulings allowing the mutual funds to whom the letters were addressed to use either wholly-owned offshore corporations or financial instruments called "commodity linked notes" to make unrestricted commodity investments, notwithstanding the 10% limit in Section 851. The IRS private letter rulings said that the mutual funds could treat the income from those sources – not as income from a commodities investment – but as income from a "securities" investment in the stock of the company they owned or in the note they designed to avoid the restrictions of Section 851.

For example, the IRS allowed mutual funds to establish wholly-owned controlled foreign corporations or CFCs whose sole function is to trade commodities in the futures and swaps markets. In every case we've examined, mutual funds have established these CFCs as offshore shell corporations in the Cayman Islands, the classic example of a tax haven. The CFCs have no offices, no employees of their own, no independent business operations, and their commodity portfolios are run by employees who work in the United States for the mutual fund that set up the offshore arrangement. For example, one mutual fund told us all of the commodity investment decisions for their offshore corporation were made by the mutual fund's employees in Rockville, Maryland. Another told us all commodity trading decisions were made by their traders in New York. Still another mutual fund told us openly that their offshore commodity fund had no "Cayman presence," describing it as "smoke and mirrors" to obtain the tax benefit.

These CFCs are corporate fictions, offshore shams, paper exercises whose sole purpose is to make a blatant end-run around the legal restrictions on commodity investments by mutual funds. At the same time, the IRS has issued private letter rulings explicitly allowing these offshore schemes. The IRS private letter rulings provide, for example, that if a mutual fund owns the stock of the offshore shell corporation it established, it can treat income from commodity investments made by that offshore shell corporation and distributed back to the United States as income from a securities investment rather than a commodities investment.

In addition, the IRS has issued private letter rulings stating that mutual funds can use commodity-linked notes to invest in commodities and treat the resulting income as from a securities investment, even though the notes were created for the sole purpose of investing in commodities and end-running Section 851.

By treating this type of income as derived from securities rather than commodities, the IRS has elevated form over substance, enabled mutual funds to use agents as though they were independent actors, and use financial engineering to do indirectly what the law doesn't let them do directly. The result is opening the door to increasing commodity speculation.

But that's not all. In the past, under the 90% rule, mutual funds spent the lion's share of their money on stocks, bonds, and other securities – providing needed capital for economic growth and jobs. They were an engine of investment in America. But as the commodity spigot opens, every dollar spent on commodity speculation diverts money from their securities investments. So instead of investing in U.S. businesses, mutual funds will spend increasing sums making bets on commodity price movements. Capital investments do our economy a lot more good than betting on prices.

**Contradicting Congressional Intent on Commodities.** To understand the context of the issues at stake, let's take a quick look at the history of the tax law's limits on mutual funds. When federal tax breaks for mutual funds were first enacted in 1936, Congress adopted limits on what mutual funds could invest in – they allowed mutual funds to utilize income from interest, stock dividends, and stock sales. Commodities were not on the list of allowed investments. That was the same year Congress enacted the Commodities Exchange Act of 1936, the first federal law to control excessive speculation in commodity markets. So Congress was well aware of U.S. commodity markets and didn't make commodities an allowable investment for mutual funds in 1936.

In 1954, Congress enacted Subchapter M of the Internal Revenue Code to reform taxation of mutual funds. Subchapter M again listed the types of income that mutual funds were allowed to earn in exchange for favorable tax treatment. That list was unchanged from 1936, and commodities were not on the list.

In 1986, fifty years after the first mutual funds got started, Congress slightly expanded the types of income that a mutual fund could earn while retaining its tax advantages, adding investments in foreign currencies to investments in securities. Commodities were not added by Congress. The Treasury Department issued a letter at the same time noting that it "would generally not treat as qualifying income gains from trading commodities."

In 2010, the mutual fund industry supported an unsuccessful legislative attempt to change the tax code to allow mutual funds to make unrestricted commodity investments. As introduced in 2009, and passed by the House in 2010, the Regulatory Investment Company Modernization Act would have explicitly permitted mutual funds to utilize income from "commodities" under Section 851. But the Senate did not accept that provision. It was removed from the bill which only then was approved by the Senate. Removal of the commodities provision was, in fact, the only change made in the House-passed bill. The bill was sent back to the House which agreed to the bill as amended by the Senate. So the short story is that Congress did not agree to adding commodities to the list of acceptable income for mutual funds under the 90% rule. If the industry wants to try again to change the law to allow more commodity investments by mutual funds, the change should be made, not by private letter rulings or regulation, but by Congress after a full debate of the pros and cons.

Six months after Congress made its decision in the RIC Modernization Act, in June 2011, the IRS suspended its issuance of new private letter rulings in this area, so it could review the underlying policy issues. Later in the year, Senator Coburn and I sent a joint letter to Treasury and the IRS asking the IRS "to permanently halt the further issuance of [the] private letter rulings." Our letter is Hearing Exhibit 1d.

**Shams and Conduits.** Some have suggested that the IRS ought to allow mutual funds to use offshore corporations to make commodity investments based on the court case known as Moline Properties, which required the IRS to recognize a corporate structure. But in Moline Properties, the Supreme Court also stated that, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal." The Cayman corporations being used for mutual fund commodity investments have no employees, no place of business, no profits of their own, and no obvious nontax purpose. There is no there, there. They are exactly the type of sham corporations that the Supreme Court said the IRS can disregard.

Another relevant event is the 2010 Congressional codification of the economic substance doctrine which permits the IRS to disregard transactions that have no substantial nontax purpose. Mutual funds have not offered any substantial business or economic purpose for creating these offshore CFCs or constructing commodity-linked notes. Their only purpose is to serve the mutual funds' effort to re-characterize the resulting income as derived from "securities," so they can make unlimited commodity investments while retaining their privileged tax status. A Tax Notes analysis by two tax practitioners, Hearing Exhibit 3d, observed that "it is hard to imagine that there could be a nontax purpose outweighing the tax purpose on the facts of the rulings."

Finally, there is a long line of cases and private letter rulings in which federal courts have upheld IRS efforts to go after sham corporations or transactions which have no purpose other than tax avoidance or which serve only as conduits for parties seeking to avoid taxation. They include cases like Gregory v. Helvering, Aldon Homes, Aiken Industries, and the recent case of Southgate Master Fund, LLC. In Southgate, the Fifth Circuit, citing numerous precedents, wrote the following:

> "The starting point for our analysis is the cardinal principle of income taxation: a transaction's tax consequences depend on its substance, not its form. This principle 'is no schoolboy's rule; it is the cornerstone of sound taxation[.]' … This foundational principle finds its voice in the judicial anti-abuse doctrines, which 'prevent taxpayers from subverting the legislative purpose of the tax code by engaging in transactions that are fictitious or lack economic reality simply to reap a tax benefit.'"

One of the issues we will explore today is why the IRS did not follow this approach when analyzing requests by the mutual funds to use offshore corporations and structured notes to make their commodity investments. By issuing the private letter rulings that it has in the mutual fund area, the IRS is undermining its own longstanding efforts to go after sham corporations and transactions used to avoid paying tax.

These are not arcane tax issues; they raise fundamental issues affecting our economic future, the functioning of our tax code, and the use of offshore schemes and financial engineering to avoid our tax laws. The IRS private letter rulings have unleashed a new flood of speculative commodity investments damaging to American families, businesses, and our economy. Commodity speculation that contributes to $4 gasoline is no joke, and neither is a tax policy that threatens to fuel a new explosion in commodity speculation. The IRS letter rulings enable U.S. firms to use offshore shell corporations and financially engineered notes to make commodity investments, despite longstanding tax code restrictions, setting precedents that eat away at the integrity of our tax code. Congress shouldn't just stand by and let that happen.

Today's oversight hearing is intended to address those concerns. We will hear from IRS Commissioner Douglas Shulman and Emily McMahon who is Acting Assistant Secretary of the Treasury for the Office of Tax Policy, two of the most senior tax officials in the Administration. I invite our Ranking Member, Dr. Coburn, to share his views.

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