

**PREPARED TESTIMONY
OF
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BEFORE THE
U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
HEARING ON INVESTMENTS IN COMMODITIES BY
REGULATED INVESTMENT COMPANIES
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Introduction

Chairman Levin, Ranking Member Coburn, members of the subcommittee, thank you for this opportunity to testify on the issue of regulated investment companies (RICs) investing in commodities.

I would start by explaining that the IRS is involved in this issue because it is charged with providing guidance to taxpayers as to whether investments RICs choose to make will produce qualifying RIC income, as defined in the tax law.

In order to maintain its tax status, a RIC must derive 90% of its income from investments that meet the qualifications of section 851, which generally requires that investments be related to stock, securities, or foreign currencies. The term “securities” is specifically defined in section 851 by cross reference to the definition of that same term in the Investment Company Act of 1940 (the 1940 Act).

It is the scope of that definition – and particularly its application to investments providing indirect exposure to commodities – that have been the focus of the approximately 70 private letter rulings that are the subject of this hearing.

It may be useful for me to provide a brief explanation of how the agency arrived at the position reflected in the private letter rulings and then summarize where the IRS is on this issue today. By late 2005 the investment markets had developed to a point where many RICs felt the need to add exposure to commodity prices to their investment portfolios. As a result, they requested guidance from the IRS as to whether investments made to achieve this exposure would qualify for the 90% income test. The IRS was unable to find any authoritative guidance on the proper scope of the definition of “security” from either the Securities and Exchange Commission (SEC) or the Commodities Futures Trading Commission (CFTC), which is the primary regulator for the commodity markets in the United States.

This situation resulted in the IRS being asked to issue private letter rulings addressing specific proposed RIC commodity-related investments based on the IRS’s own best interpretation of the tax law, including cross-references to the

1940 Act. Private letter rulings were issued on this subject starting in 2006. By 2010 the volume of private letter ruling requests was becoming a concern, and consideration was given to issuing some form of broader published guidance. The RIC Modernization Act was then pending, though, and at that point the bill contained a provision that would have affirmatively treated income from direct investments in commodities as qualifying income. As a result, consideration of a guidance project was put on hold. The provision in the RIC Modernization Act relating to commodities was removed prior to passage, however, leaving the statutory language on this issue unchanged.

In July 2011, the IRS notified the RIC industry that it would not issue further private letter rulings until the staff could look at the overall set of issues and consider guidance of broader applicability. That remains our current posture.

That, Mr. Chairman, is the short version. A little more detail is appropriate, however, in order to answer the specific questions you have raised. Therefore I have included in my written testimony a summary of the legal issues at stake, which was prepared by the IRS Office of Chief Counsel. That summary is included below.

This concludes my testimony. I would be happy to take your questions.

Summary of Legal Issues Surrounding Commodity-Related Investments by RICs

Internal Revenue Service 2006 Revenue Rulings

In 2006, the IRS published Revenue Rulings 2006–1 [2006-1 C.B. 261] and 2006–31 [2006-1 C.B. 1133]. These rulings addressed section 851(b)(2) of the Internal Revenue Code, which requires that each taxable year at least 90 percent of the gross income of a RIC must consist of income from specified sources (qualifying income). Qualifying income includes both gain from the sale or disposition of securities and income from securities. The Code, however, does not define the term “security.” Instead, it cross-references the 1940 Act, which is administered by the SEC. That is, section 851(b)(2) defines qualifying income as including “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 ... derived with respect to [a RIC’s] business of investing in such stock, securities, or currencies.”

At issue in Revenue Ruling 2006-1, the first of the two published rulings, was whether income from a total return swap on a commodities index would be qualifying income. The Ruling arose because the Office of Tax Policy and the IRS became aware of certain investment funds being or intended to be offered to the public as RICs that made extensive use of such instruments. Neither the 1940 Act itself, the regulations under the 1940 Act, nor SEC staff Interpretations yielded an answer to the question whether the swaps were 1940 Act securities. IRS and Treasury staff consulted with SEC and CFTC staff, but this also did not lead to an answer. In the absence of definitive guidance as to whether such a swap would be a 1940 Act security, the IRS in the Ruling examined the relevant legislative history underlying enactment of the section 851(b)(2) cross-reference to the 1940 Act, and held that “[a] derivative contract with respect to a commodity index is not a security for purposes of section 851(b)(2).”

A number of questions were quickly raised regarding Revenue Ruling 2006-1. Revenue Ruling 2006–31 was subsequently issued to modify and clarify Revenue Ruling 2006–1, including by making clear that the holding of Revenue Ruling 2006-1 was not intended to preclude income from certain instruments that create commodity exposure, such as certain structured notes, from being qualifying income.

Due at least in part to these revenue rulings, as well as the general uncertainty regarding the extent of permissible commodity-linked investments by RICs, the IRS received a large and increasing number of requests for private letter rulings. Private letter rulings can be relied upon only by the taxpayers to which they are addressed. In that sense, they can provide the IRS with a vehicle to explore market realities and test legal approaches to novel questions before promulgating published guidance in an area.

The private ruling requests asked for approval of one or both of the following positions: (1) that a RIC's income inclusion that results from its controlled foreign corporation (CFC) earning income from commodity investments is qualifying income; and (2) that income from structured notes with returns based on commodity price movements also will produce qualifying income.

Controlled Foreign Corporations

Under the first of these approaches, some RICs achieve indirect exposure to commodities by investing up to 25 percent of a fund's assets in a foreign subsidiary that is treated as a CFC. The CFC then makes commodity-related investments. The U.S. parent RIC generally includes amounts in income under subpart F of the Code when the CFC earns income from its commodity investments. The nature of the income – from the standpoint of the RIC – is simply a subpart F income inclusion, and not identified as income from an investment in commodities.

The Code generally permits a RIC to hold all of the shares of a subsidiary if the value of that holding does not exceed 25 percent of the value of the RIC's total holdings. Moreover, Congress expressly addressed the issue of subpart F income inclusions in the so-called "flush language" of section 851(b). That paragraph of section 851(b) treats a subpart F inclusion as a dividend for this purpose, and hence as qualifying income, if there is a matching distribution out of earnings and profits.

Independent of the "flush language," some RICs sought private letter rulings to determine whether a subpart F inclusion could constitute qualifying income on the separate basis that such income is "other income" derived with respect to the RIC's business of investing in the stock of the subsidiary under section 851(b)(2). At the time of the rulings, IRS staff took the position that the two provisions were not intended to be coordinated because, among other reasons, they were introduced into the legislative process with no indication that the "flush language" was intended to limit the "other income" provision. Therefore, the staff concluded that, rather than having one provision narrow the other, the "other income" clause should be evaluated without regard to the "flush language." The rulings concluded that subpart F inclusions could be treated as "other income," and accordingly that current distributions from the CFCs were not required for such inclusions to be qualifying income.

The private letter rulings assume that the CFC is treated as a corporation that is separate from the RIC. This approach reflects several considerations, including section 851's express contemplation that RICs might own CFCs, the tax law principle that a taxpayer's choice of entity for conducting investment or business activity should generally be respected, and the tax law principle that, if properly organized and managed, a corporation should generally be respected as separate from its shareholders for tax purposes.

Commodity-linked Structured Notes

The second approach covered by the private letter rulings relates to structured notes with a return based on movements in commodity prices. A commodity-linked structured note is an instrument entered into with a counterparty, generally a financial institution. In addition to interest on its investment, a RIC receives income measured, or “structured,” with reference to the movement of the value of a commodity index or indices, often with a leverage factor.

The structured notes rulings, in general, are based on the premise that structured notes with enough resemblance to typical debt instruments and characteristics suggesting some minimum certainty of repayment of principal, such as a minimum of 51 percent principal protection and related features, may qualify as a “note,” an “evidence of indebtedness,” or an “investment contract” within the 1940 Act definition. Some of the factors the IRS looked for included up-front payment in full of the purchase price of the note; a short, fixed maturity (often, a year and a day); an automatic redemption feature, termed a “knockout,” that triggers the note’s redemption if the index falls too far in value; and the note not being subject to mark-to-market margining requirements, or treated as a contract of sale of commodities for future delivery (or as an option on such a contract), under the Commodities Exchange Act.

It has been argued that derivatives of all types are outside the definition of “security” under the 1940 Act. It is true that derivatives were not widely viewed as investment vehicles when the 1940 Act was enacted. The 1940 Act’s definition of “security,” however, is not static, and contains several generic items designed to encompass new instruments as they develop, including “evidence of indebtedness,” “investment contract,” and any “instrument commonly known as a ‘security’.” The extent to which investments with commodity-linked payoffs are also securities and, if so, how they are identified, have been active subjects of comment in the securities law area for some time, but there do not appear to be any conclusive answers.

Recent Legislative Actions

Section 201 of the RIC Modernization Act as originally introduced would have allowed income from direct investment in commodities to be qualifying income. However, the Senate amended the bill to remove section 201 before passing the RIC Modernization Act by unanimous consent. The removal of section 201 of the bill left the statutory language unchanged. There was no change to the cross-reference to the 1940 Act or to the definition of “security” under that Act.

Additionally, the Dodd–Frank Wall Street Reform and Consumer Protection Act amended both the federal commodity and securities laws to provide the CFTC with jurisdiction over swaps, including those on broad-based security indices. It also provided the SEC with jurisdiction over security-based swaps, which are

swaps on narrow-based security indices and single securities. The two agencies share authority over mixed swaps, which are swaps that have mixed attributes.

However, Dodd-Frank did not make any explicit change to the definition of “securities” in the 1940 Act.

Current Status of IRS Advice

This history has led to the current IRS position. The number of RIC requests for private letter rulings increased dramatically since 2006, creating concern within the IRS from both an administrative and a technical standpoint. After the RIC Modernization Act failed to provide a clear, unambiguous answer, the IRS decided to stop issuing private letter rulings until it could provide guidance of general applicability. The possibility of that guidance is currently under consideration.