

**Testimony of Emily S. McMahon, Acting Assistant Secretary for Tax Policy,
U.S. Department of the Treasury
Before the U.S. Senate Homeland Security and Government Affairs Permanent Subcommittee
on Investigations
Hearing on “Compliance with Tax Limits on Mutual Fund Commodity Speculation”
January 26, 2012**

Chairman Levin, Ranking Member Coburn, and members of the Subcommittee, I appreciate the opportunity to testify on the issue of investments in commodities by regulated investment companies (RICs).

Treasury’s Role in the RIC Guidance

Commissioner Shulman’s testimony describes a series of private letter rulings issued by the Internal Revenue Service (IRS) on this subject. I would like to begin by describing the role of the Treasury Department in the private letter ruling and published guidance process. A private letter ruling is a determination issued by the IRS to a particular taxpayer that interprets and applies the tax laws to the taxpayer’s particular set of facts. As a matter of policy and practice, the Treasury Department does not participate in the consideration or issuance of private letter rulings by the IRS. Moreover, other than in highly unusual circumstances, Treasury Department personnel do not know which taxpayers have requested or received private letter rulings. Treasury Department personnel become aware of the issuance of a private letter ruling only when that ruling is eventually issued to the public by the IRS in redacted form. Consistent with that policy and practice, the Treasury Department did not participate in the formulation, or review or oversee the issuance, of any of the private letter rulings addressing commodity-related investments by RICs. Nor has the Treasury Department studied the effect of the private letter rulings on the mutual fund industry.

The Office of Tax Policy is actively involved, however, in the development of published guidance, including both tax regulations and other administrative guidance that is published in the Internal Revenue Bulletin. In this capacity, Treasury personnel participate in the development of the substantive law that private letter rulings reflect.

Thus, in 2005 and 2006, Treasury Department personnel did participate in the development of two published revenue rulings that address commodity-related investments by a RIC. These revenue rulings, Rev. Rul. 2006-1, 2006-1 C.B. 261, and Rev. Rul. 2006-31, 2006-1 C.B. 1133, are described in Commissioner Shulman’s written testimony. Subsequent to those revenue rulings, the IRS and Treasury Department periodically discussed the possibility of additional guidance in this area as a candidate for the Priority Guidance Plan.

Suspension of the Issuance of Private Letter Rulings in This Area and Subsequent Developments

As stated in Commissioner Shulman’s testimony, the IRS has suspended the issuance of private letter rulings addressing commodity-related investments by RICs. Treasury Department personnel were not involved in that decision.

Subsequent to the suspension, the Investment Company Institute (ICI) called several members of the staff of the Office of Tax Policy to ask why the IRS issuance of rulings had been suspended and what the future might hold. Treasury staff could not, and did not, provide answers to those questions. On September 28, 2011, at the ICI’s request, ICI representatives met with Treasury and

IRS personnel to discuss ICI proposals for published guidance that would permit commodity-related investments by RICs.

The Treasury Department and IRS are considering the possibility of issuing published guidance on the subject of commodity-related investments by RICs.

Regulated Investment Company Modernization Act of 2010

This Subcommittee's letter inviting me to testify at this hearing stated that the Regulated Investment Company Modernization Act of 2010 (RMA), Pub. L. No. 111-325, 124 Stat. 3537, "reaffirmed [Congress'] intent to exclude commodities from mutual funds' qualifying income under Section 851(b)(2)." The House version of the bill (H.R. 4337) would have expanded the definition of qualifying income to include income derived from direct or indirect exposure to commodities. However, that amendment to the definition was removed from the bill before enactment, leaving unchanged the statutory provisions upon which the IRS revenue rulings and private letter rulings were based. Under those provisions, the definition of qualifying income is linked to the 1940 Act definition of "security," and income derived from such securities is not explicitly excluded from qualifying income merely because it reflects exposure to commodity prices.

Economic Substance Doctrine

Under section 7701(o) of the Internal Revenue Code (the Code), whenever the economic substance doctrine is relevant to a transaction, the transaction is treated as having economic substance only if, as a factual matter, (1) the transaction changes in a meaningful way the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into the transaction. These questions are inherently factual. The private letter rulings issued by the IRS do not address the potential application of the economic substance doctrine, and the Treasury Department does not have independent knowledge of the facts underlying the rulings. Therefore, we cannot express a view on the application of section 7701(o) to the transactions described in the private letter rulings.

Tax Policy Issues

The extent to which investors should be able to obtain exposure to commodity price fluctuations through investments in RICs is not fundamentally a tax policy issue. The Code provisions in question do raise, however, the issue of whether the Treasury Department and the IRS should be required to interpret a non-tax statute (in this case, the 1940 Act) that does not otherwise fall within their jurisdiction in order to determine the availability of favorable tax treatment under the Code. The Securities and Exchange Commission (SEC) has not issued any guidance of which we are aware that addresses whether the financial instruments described in the IRS private letter rulings are securities for 1940 Act purposes (as required to produce qualifying income). At the same time, we are not aware of any action the SEC has taken to preclude RICs from making these investments. Administering the relevant Code provisions under these circumstances is challenging from both a practical and a policy perspective.

Thank you, and I look forward to taking your questions.