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Fund Investment in Commodities Provides Opportunity and Diversification for Investors

By Karen Lau Gibian and Rachel Graham

On Capitol Hill, a hearing at the Permanent Subcommittee on Investigations (PSI) raises questions about mutual fund investors' ability to get commodity exposure in their portfolios and suggests the Internal Revenue Service (IRS) should no longer allow this type of investment.

By way of background, mutual funds can invest directly or indirectly in commodities. Investing indirectly in commodities, through a controlled foreign corporation (CFC) or a commodity-linked note (CLN), provides shareholders with exposure to commodities and is clearly permitted under the tax law. ICI's response to the January 26 PSI hearing about mutual funds' investment in commodities explains the issue in detail. The key points include:

- **Retail investors should continue to have the opportunity to diversify their investment portfolios.**

It makes good, basic investing sense for investors to have portfolios diversified beyond stocks and bonds, and commodity exposure gives the investor such opportunities. Commodities can be a good hedge against inflation and turbulence in other areas of the financial markets. Mutual fund investment is one way in which retail investors can get exposure to commodities. Other means, such as exchange-traded notes, are not subject to the substantial investor protections afforded to fund investors under the securities laws.

- **There is strong legal support for the IRS's private letter rulings that allow mutual funds to invest indirectly in commodities on behalf of their investors.**

The tax law clearly permits mutual funds to invest indirectly in commodities through CFCs or CLNs. Moreover, no Congressional policy prohibits fund investment directly or indirectly in commodities. The IRS has issued more than 70 private letter rulings that allow mutual funds to gain commodity exposure through CFC and CLN investments.

- **Funds invest through CFCs and CLNs to minimize the tax burden on shareholders.**

Mutual funds are limited in their ability to invest directly in commodities without exposing their shareholders to tax at the fund level. The tax law, however, permits funds to invest indirectly, through CFCs and CLNs, without subjecting shareholders to additional tax on their investment.

- **Many different organizations and businesses invest in CFCs to get commodity exposure and for legitimate tax purposes.**

Investing through CFCs is a well-established practice for many entities, including pension funds, universities, and charitable organizations. For example, many tax-exempt entities use CFCs to invest in real estate in order to gain exposure to such investments without generating taxable income.

- **Mutual fund investors are protected by stringent Securities and Exchange Commission regulations.**

Mutual funds are among the most regulated investment vehicles in the United States. The SEC's regulatory structure is first and foremost focused on investor protection. Even though CFCs are established overseas, they remain subject to regulation under U.S. law.

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