INTERNAL REVENUE SERVICE

IRS News Release

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# IRS Issues Guidance on Investments by Mutual Funds in Commodity-Index Contracts

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WASHINGTON — The Internal Revenue Service today issued guidance to clarify that income from commodity-index derivative contracts does not help a fund qualify for the tax benefits usually enjoyed by mutual funds. The IRS also stated that it will apply the newly announced position prospectively, to give funds enough time to adapt to the position and to communicate that response to their shareholders.

Some funds have entered into these derivatives to provide their shareholders with a total-return exposure to changes in the value of commodity indices. Many investment managers consider commodity exposure an important component of investors' overall portfolio, in part as a hedge against inflation. Investments that create this exposure include exchange-traded commodity futures contracts and interests in commodity-trading partnerships. Historically, however, mutual funds did not offer this exposure directly, because, under the tax law applicable to these funds, direct investments in commodities do not generate qualifying income for a mutual fund.

The IRS has received a number of inquiries from mutual fund sponsors concerning whether commodity-derivative investments, particularly derivative contracts on a commodity index, give rise to qualifying income under 1986 tax legislation liberalizing the qualifying income requirement. In recent months, even in the absence of guidance from the IRS, some funds filed prospectuses with the Securities & Exchange Commission, indicating that the funds may enter into these investments.

Revenue Ruling 2006–1 provides guidance in this area. Consistent with the purposes stated by the sponsors of the 1986 tax legislation and with changes to the statutory language made during Congressional consideration of it, the ruling holds that income and gains from indirect investments in commodities via certain derivative contracts are not qualifying income for mutual funds.

The IRS will not apply the holding of the revenue ruling adversely to income that a mutual fund recognizes on or before June 30, 2006. As a result of this delayed effective date, funds that may have entered into commodity-based derivative contracts will have a reasonable time to adjust their investments to ensure continued compliance with the tax rules for mutual funds.

Rev. Rul. 2006-1 is attached and will appear in Internal Revenue Bulletin 2006-2, dated January 9, 2006

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