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Oil Spill

A year ago, Senators Ron Wyden (Democrat, Oregon) and Charles Grassley (Republican, Iowa) released a discussion draft of a bill that would eliminate the favourable tax treatment of direct and certain derivative investments in oil, natural gas or any primary product of oil or natural gas (such as diesel and gasoline), and solicited public comments. On August 6 2009, senator Wyden introduced the Stop Tax-breaks for Oil Profiteering Act (the STOP Act) in the Senate and proposed legislation based on the discussion draft released in 2008. The STOP Act is intended to temporarily curb excessive speculative trading in the oil and gas futures markets and thereby temper the rise in the price of oil. If enacted into law, the legislation would apply to transactions entered into during a period of a little more than four years. The STOP Act has been referred to the Senate Finance Committee. It is impossible to predict its progress in the legislative process and whether and in what form it may be enacted into law.

The STOP Act would apply to any "applicable commodity" acquired after August 31 2009 and before January 1 2014, defined as: (1) actively traded oil or natural gas (or any primary product of oil or natural gas); (2) an index, a "substantial portion" of which is based on actively traded oil or natural gas; (3) a notional principal contract with respect to oil, natural gas or an index described under (2) above; and (4) any evidence of an interest in, or a derivative instrument (including any option, forward contract, futures contract, short position, and any similar instrument) in actively traded oil or natural gas, or in an index or notional principal contract (as described under (2) and (3) above).

Under current law, direct and derivative interests in commodities are treated as capital assets in the hands of non-dealers and, as such, give rise to capital gains or losses. Long-term capital gains recognised by an individual are generally subject to tax at preferential rates, whereas short-term capital gains are generally subject to tax at ordinary income rates. The STOP Act would treat all gain or loss from the sale or exchange of any applicable commodity, which would otherwise be treated as long-term capital gain or loss, as short-term capital gain or loss.

Income derived through certain specified contracts such as regulated futures contracts, foreign currency contracts, non-equity options, and dealer equity options is subject to special rules under Section 1256 of the Internal Revenue Code. Under Section 1256 of the Code, income with respect to these contracts is taxed at a blended rate: 40% of gain or loss is treated as short-term capital gain or loss and 60% of gain or loss is treated as long-term capital gain or loss. The STOP Act would treat all gain or loss with respect to a contract that is subject to Section 1256 of the Code that is an applicable commodity as short-term capital gain or loss.

The STOP Act would treat any gain or loss recognised upon the sale or exchange of a partnership interest (such as an interest in a hedge fund or investment partnership) as short-term capital gain or loss to the extent a portion of it is attributable to unrecognised gain or loss with respect to any applicable commodity.

Tax-exempt organisations are generally subject to tax at corporate rates on any "unrelated business taxable income" (UBTI). However, gain recognised upon the sale or exchange of property (other than stock in trade, inventory, property held for sale to customers in the ordinary course of business or debt financed property) generally does not constitute UBTI. Furthermore, a tax-exempt organisation generally is not considered to recognise UBTI if it holds an investment in a foreign corporation that derives income that would be treated as UBTI if derived directly by the tax-exempt organisation.

The STOP Act would treat any income, gain or loss derived by a tax-exempt organisation with respect to any applicable commodity as UBTI. In addition, if a tax-exempt organisation holds an interest in a foreign corporation, it would be required to take into account, on a current basis without regard to whether there was an actual distribution from the corporation to the organisation, its pro rata share of any income, gain or loss of such foreign corporation with respect to any applicable commodity as if the tax-exempt organisation held such commodities directly. Finally, the STOP Act would require a tax-exempt organisation to recognise UBTI on the sale or exchange of stock in a foreign corporation to the extent a portion of such gain or loss is attributable to unrecognised gain or loss with respect to any applicable commodity.

The STOP Act raises a number of issues and questions. First, it is unclear what portion of an index must be based on actively traded oil or natural gas for it to be *substantial* within the meaning of the proposed legislation. Second, the STOP Act can be expected to have far-reaching consequences for any tax-exempt organisation holding stock in a foreign corporation that has income, gain or loss from any applicable commodity. Such corporations could include widely held international oil and gas companies. It is interesting to note that an exempt organisation investing in a *domestic* oil company would not be subject to the same rules. Third, whether intended or not, it would appear that an applicable commodity would include exchange-traded notes or other structured notes that are linked to oil, natural gas, or an oil or gas index. Finally, the STOP Act would affect the taxation of an investment in exchange-traded funds holding an applicable commodity whether or not they are treated as partnerships for federal income tax purposes. Most exchange-traded funds are structured as "regulated investment companies" for federal income tax purposes, and not as partnerships. In either case, all or a portion of the gain from an investment in applicable commodities through exchange traded funds likely would lose its preferential treatment if the STOP Act is enacted into law.

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