TECHNICAL EXPLANATION OF

STOP TAX-BREAKS FOR OIL PROFITEERING ACT (STOP ACT)

A. Present Law

1. Taxation of Sales and Exchanges of Commodities by U.S. Persons

Under present law, the character of gains or losses realized by a U.S. person selling or exchanging a commodity is largely a function of the taxpayer's status as (i) an investor, (ii) a trader or dealer in oil or natural gas, or (iii) a business that either produces oil or natural gas (and holds it as inventory) or uses oil or natural gas in the ordinary course of business.

Investors in commodities, that is, persons who buy and sell commodities for their own account and not as part of a trade or business, hold commodities as capital assets. As a result, their gains and losses from the sale or exchange of commodities are taxed as capital gains or losses.[1] The same rule applies to traders in these commodities, other than traders that elect mark-to-market treatment under section 475 of the Internal Revenue Code of 1986, as amended (the "Code").

On the other hand, gains or losses from the sale or exchange of a commodity are treated as ordinary income or loss by (i) persons who treat oil or natural gas as inventory (e.g., producers of these commodities), (ii) dealers in commodities, (iii) traders in commodities that have elected mark-to-market treatment under Code section 475, (iv) businesses that sell or exchange such commodities as part of a hedging transaction, as defined in Code section 1221(a)(7), or (v) persons who regularly use or consume such commodities in the ordinary course of their trade or business.

Capital Gains Treatment

In general, adjusted net capital gain of an individual is subject to a maximum tax rate of 15 percent.[2] There is no preferential rate for capital gains of corporations.

Net capital gain is the excess of net long-term capital gains over net short-term capital losses.[3] Short-term capital gains and losses are gains and losses from the sale or exchange of capital assets held by the taxpayer for not more than one year.[4] Long-term capital gains and

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[1] *See, generally*, Code section 1221 (defining capital assets); *N. Boatner v. Comm'r*, TC Memo 1997-379 (discussing the distinctions between traders, investors, and dealers).

[2] Code Sec. 1(h).

[3] Code Sec. 1222(11).

[4] Code Sec. 1222(1) and Code Sec. 1222(2).

losses are capital gains and losses from the sale or exchange of capital assets held by the taxpayer for more than one year.[5]

Because net capital gain is defined as the excess of net long-term capital gains over net short-term capital losses, an individual that has both net long-term capital gains and net short-term capital *gains* is taxed at the preferential net capital gain rate only with respect to the individual's net long-term capital gains. Any short-term capital gains are taxed at ordinary income rates.

Capital losses are allowed only to the extent of capital gains, plus, in the case of individuals, $3,000.[6] Capital losses of individuals may be carried forward indefinitely; capital losses of corporations generally may be carried back three years and forward five years.[7]

2. Taxation of Derivatives with respect to Oil and Natural Gas

Derivatives with respect to oil or natural gas that are "section 1256 contracts" (defined below) are taxed in a different manner than other derivatives with respect to oil or natural gas.

Section 1256 Contracts

Code section 1256(b) defines the term "section 1256 contract" to include, among other things, any "regulated futures contract," e.g., certain contracts for future delivery of commodities, including oil or natural gas, and "nonequity options," e.g., options traded on a qualified board or exchange for the purchase or sale of commodities. In general, Code section 1256 requires taxpayers to treat each section 1256 contract as if it were sold (and repurchased) for its fair market value on the last day of the year (i.e., "marked to market").

Any gain or loss with respect to a section 1256 contract that is subject to the mark-to-market rule is treated as short-term capital gain or loss (to the extent of 40 percent of the gain or loss) and long-term capital gain or loss (to the extent of the remaining 60 percent). Also treated this way are the gains and losses upon the termination (or transfer) of a section 1256 contract, whether by offsetting, taking or making delivery, by exercise or by being exercised, by assignment or being assigned, by lapse, or otherwise.

This special "60/40 rule" does not apply to (i) hedging transactions (as defined in Code section 1221(b)(2)(a)), (ii) a section 1256 contract that is part of a mixed straddle if the taxpayer makes the appropriate election, or (iii) any section 1256 contract held by a dealer in commodities or by a trader in commodities that makes the mark-to-market election in Code section 475.[8]

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[5] Code Sec. 1222(3) and Code Sec. 1222(4).

[6] Code Sec. 1211.

[7] Code Sec. 1212.

[8] *See* Code section 475(d)(1).

Other Derivatives

A number of other complex rules apply to the taxation of derivatives that are not section 1256 contracts. Such derivatives include over-the-counter commodity options and forward contracts (i.e., options and forward contracts not traded on a regulated exchange) and notional principal contracts with respect to commodities.

Under present law, a taxpayer can use derivatives that are not section 1256 contracts to achieve virtually identical economic results while avoiding the mark-to-market rule in Code section 1256. For example, a taxpayer seeking to take a long position in oil that wants to (i) defer all gains and losses until the time the taxpayer unwinds its position and (ii) preserve the possibility of 100-percent long-term capital gain treatment (which is not possible for section 1256 contracts subject to the rules in Code section 1256(a)) can enter into an over-the-counter forward contract. Because such a contract is not a section 1256 contract, the taxpayer is not required to mark the contract to market at the end of the year (assuming the taxpayer is not subject to the mark-to-market requirements of Code section 475). In addition, the taxpayer may be able to recognize long-term capital gain when the contract is terminated.

3. Tax Treatment of Gains and Losses from the Sale of Commodities by Tax-Exempt Entities

Code section 511 imposes tax on the "unrelated business taxable income" (or "UBTI") of certain organizations that otherwise are exempt from tax, namely organizations described in Code section 501(c) (e.g., charities, social welfare organizations, trade associations, etc.), pension funds described in section 401(a), and state colleges and universities. UBTI generally is taxed at the rates applicable to business corporations; UBTI of charitable trusts described in Code section 511(b)(2) is taxed at the rates generally applicable to trusts.

In general, UBTI is defined as gross income derived by any tax exempt organization from any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of the organization's exempt purpose.[9] Under present law, gains from the sale or exchange of property (including oil or natural gas), other than property that is stock in trade, inventory, or held for sale to customers in the ordinary course of business, are not treated as UBTI and are not are not subject to the tax imposed by Code section 511.[10]

A primary reason for imposing the unrelated business income tax was to end a source of unfair competition, by placing the unrelated business activities of certain exempt organizations on the same tax basis as the nonexempt business endeavors with which they compete.[11]

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[9] *See* Code sections 512 and 513.

[10] Code Sec. 512(b)(5).

[11] Treas. Reg. sec. 1.513-1(b).

Passive income, such as dividends, interest, royalties, certain rents, and certain gains and losses from the sale or exchange of property, is exempt from UBTI.[12] In general, the exemption for such passive income applies unless the income is derived from debt-financed property[13] or is in the form of certain payments from certain 50-percent controlled subsidiaries.[14]

The IRS has concluded in a series of private letter rulings that, where UBTI-producing assets are owned by a corporation, or an entity that elects to be treated as a corporation for Federal tax purposes, and an exempt organization invests directly or indirectly in such corporation or entity, the exempt organization generally will not recognize UBTI as a result of the investment. When such entities are interposed between an exempt organization investor and assets that would give rise to UBTI if owned by the exempt organization directly (or through a pass-through entity) they commonly are referred to as "UBIT blockers" or "blocker corporations." UBIT blockers may be established offshore in tax haven jurisdictions to avoid or minimize tax at the blocker corporation level.

B. Description of the Bill

1. Treatment of Gains and Losses from the Sale or Exchange of Applicable Commodities

Under the proposal, any gain or loss from the sale or exchange of any "applicable commodity" that otherwise would be long-term capital gain or loss is treated as a short-term capital gain or loss, notwithstanding the taxpayer's holding period with respect to such commodity.

The term "applicable commodity" means (i) oil or natural gas (or any primary product of oil or natural gas) which is actively traded (within the meaning of Code section 1092(d)(1)), (ii) a specified index (within the meaning of Code section 1221(b)(1)(B)(ii)) a substantial portion of which is, as of the date the taxpayer acquires its position with respect to such specified index, based on oil or natural gas, (iii) any notional principal contract with respect to oil, natural gas, or a specified index, a substantial portion of which is based on oil or natural gas, and (iv) any evidence of an interest in, or a derivative instrument in, any such commodity, specified index, or notional principal contract, including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity, specified index, or national principal contract.

The proposal includes within the definition of "applicable commodity" any "specified index" a substantial portion of which is, as of the date the taxpayer acquires its position with respect to such specified index, based on oil or natural gas. Code section 1221(b)(1)(B)(ii) defines a "specified index" as any one or more or any combination of (i) a fixed rate, price, or amount, or (ii) a variable rate, price, or amount, which is based on any current, objectively determinable financial or economic information with respect to commodities which is not within

[12] Code Sec. 512(b)(1) – (3), (5).

[13] Code Sec. 512(b)(4).

[14] Code Sec. 512(b)(13).

the control of any of the parties to the contract or instrument and is not unique to any of the parties' circumstances. Thus, for example, the term "applicable commodity" includes an index future the value of which is based on the aggregate value of a basket of exchange-traded commodities contracts if, as of the date the taxpayer acquires such index future, a substantial portion of the contracts in the basket are contracts with respect to oil or natural gas.

The proposal affects the character of income from applicable commodities that otherwise would be long-term capital gain or loss; it does not recharacterize amounts that, without regard to the proposal, would be short-term gain or loss or ordinary income. For example, the proposal does not affect the ordinary income recognized by (i) a person who treats an applicable commodity as inventory (e.g., a producer of an applicable commodity), (ii) a dealer in commodities, (iii) a trader in commodities that has elected mark-to-market treatment under Code section 475, (iv) a business that sells or exchanges an applicable commodity as part of a hedging transaction, as defined in Code section 1221(a)(7), or (v) a person who regularly uses or consumes an applicable commodity in the ordinary course of such person's trade or business.

Where a partnership holds an applicable commodity, and a partner sells or exchanges an interest in such partnership, the proposal treats the portion of the partner's gain or loss that is attributable to the unrecognized gain or loss of the partnership with respect to such applicable commodity as short-term capital gain or loss, provided the partner otherwise would not be required to treat the gain or loss as ordinary income or loss, e.g., under section 751.

2. Treatment of Section 1256 Contracts that are Applicable Commodities

Under the proposal, any gain or loss of a taxpayer with respect to a section 1256 contract that is an applicable commodity, and that under present law would be recharacterized pursuant to the 60/40 rule in Code section 1256(a)(3) as 60 percent long-term capital gain or loss and 40 percent short-term capital gain or loss, is treated as 100 percent short-term capital gain or loss.

To prevent avoidance of the rule in proposed Code section 1256(f), which recharacterizes gains and losses from section 1256 contracts that are applicable commodities as 100 percent short-term capital gain or loss, the proposal provides that a taxpayer may not make an election under Code section 1256(d) or the regulations prescribed pursuant to Code section 1092(b)(2), with respect to any mixed straddle, if any position forming a part of such mixed straddle is an applicable commodity. In addition, for purposes of new Code section 1256(f), if any section 1256 contract that is part of a straddle is an applicable commodity, any other section 1256 contract that is part of such straddle shall be treated as an applicable commodity. Thus, for example, if a straddle is comprised of a section 1256 contract that is an applicable commodity and another section 1256 contract (that is not an applicable commodity), all gain or loss with respect to both positions would be short-term gain or loss, provided both positions are otherwise subject to Code section 1256(a).

The proposal also amends section 1212(c) of the Code, which provides a special rule for non-corporate taxpayers for the carryback of losses from section 1256 contracts to offset prior gains from such contracts. Under the proposal, loss carrybacks under Code section 1212(c) from applicable commodities that are section 1256 contracts are treated as 100 percent short-term capital loss.

3. Treatment of Income or Gains of Tax-Exempt Organizations with respect to Applicable Commodities

The proposal amends Code section 512 to require tax exempt organizations to take income, gain, or loss with respect to applicable commodities into account as income, gain, or loss from an unrelated trade or business (i.e., as unrelated business taxable income, which is taxable at the rates applicable to corporations or trusts).[15] Such organizations may reduce income or gain with respect to applicable commodities by the amount of all deductions directly connected with such income or gain. Losses incurred by a tax exempt organization with respect to applicable commodities generally may be offset against the organization's income or gain with respect to applicable commodities.

In order to prevent a tax-exempt organization from avoiding tax on UBTI by holding commodities through a foreign blocker corporation, the provision imposes a look-through rule where a tax-exempt organization directly or indirectly owns stock in a foreign corporation that owns any applicable commodity. As a result, gains and losses of a foreign corporation from the sale, exchange, or marking to market of applicable commodities flow through to any tax-exempt organization that owns stock in such foreign corporation and are treated as UBTI. Where a tax-exempt organization sells stock of a foreign corporation that holds applicable commodities, the portion of the tax exempt organization's gain or loss that is attributable to unrecognized gain or loss of the foreign corporation with respect to applicable commodities is treated as UBTI. The proposal requires the Secretary to provide regulations to prevent the double counting of any income that flows through to a tax exempt organization under the provision. For example, where a tax exempt organization is taxed on commodities gain recognized by a foreign corporation in which it holds stock and subsequently receives a dividend from such corporation that is attributable to such gains, the tax exempt organization should not be taxed again on the dividend income.

4. Study of Tax Treatment of Commodities and Section 1256 Contracts

The proposal directs the Secretary of the Treasury, or the Secretary's delegate, to conduct a study no later than January 1, 2012of the Federal income tax treatment of section 1256 contracts and of applicable commodities. In general, the study will include an analysis of the average annual number of sales or exchanges of such contracts and commodities, whether the amendments made by the proposal had any effect on they number or type of such sales and exchanges and the effect of tax policy on the operation of the commodities exchanges.

5. Effective Date and Sunset

The proposal applies to applicable commodities acquired on or after August 31, 2009, and before January 1, 2014.

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[15] The definition of "applicable commodity" is expanded for purposes of the proposed unrelated business taxable income provision to include all section 1256 contracts that are applicable commodities (i.e., the carve-out for section 1256 contracts that are required to be marked to market under Code section 1256(a) is eliminated).