

INVESTMENT FUNDS ALERT

PROPOSED LEGISLATION REGARDING TAXATION OF INVESTMENTS IN OIL AND NATURAL GAS



SUMMARY

As discussed in more detail below, new legislation has been proposed that would have the following effects in its current form –

- Subject a tax-exempt investor's income, gain and loss related to certain oil and natural gas positions to current taxation, whether earned directly or by a foreign corporation in which such tax-exempt investor holds shares
- Treat all capital gain or loss recognized by U.S. persons that relates to certain oil and natural gas positions as short-term capital gain or loss, including gain or loss triggered through a sale of a partnership holding certain positions in oil and natural gas
- Eliminate the favorable capital gain and loss treatment currently afforded to holders of "section 1256" contracts relating to oil and natural gas, which treats any gain or loss recognized with respect to such contracts as 60 percent long-term capital gain or loss and 40 percent short-term gain or loss.

INTRODUCTION

Legislation proposed on July 31, 2008, by Sens. Ron Wyden, D-Oregon and Chuck Grassley, R-Iowa, would have a profound effect on investment funds (and their investors) that engage in trading strategies relating to oil and natural gas. The legislation is intended to eliminate the favorable tax treatment afforded to investors in oil and gas commodities that is believed to be responsible in part for what is viewed as "excess speculation" causing a dramatic rise in the price of oil and natural gas. The legislation would apply to any transactions occurring between July 31, 2008 and January 1, 2013, with respect to–

1. actively traded oil or natural gas (or any primary product such as gasoline, kerosene and diesel fuel)
2. an index which is based substantially on oil or natural gas as of the date the position in the index is acquired

3. a notional principal contract with respect to oil, natural gas, or an index described above
4. any evidence of an interest in, or a derivative instrument in, any such commodity, index or notional principal contract, including an option, forward contract, futures contract, short position and similar instrument (items 1-4, “applicable commodities”)

TAX TREATMENT OF GAINS AND LOSSES FROM THE SALE OF COMMODITIES BY TAX-EXEMPT ENTITIES

A tax-exempt organization’s gross income derived from any trade or business, the conduct of which is not substantially related to the organization’s exempt purpose, is generally subject to tax as “unrelated business taxable income” (UBTI). However, gains from the sale or exchange of property (including applicable commodities), other than stock in trade, inventory or property held for sale to customers in the ordinary course of business, are generally not treated as UBTI. In addition, a tax-exempt organization generally will not recognize UBTI as a result of an investment in a foreign corporation that holds UBTI-producing assets.

The proposed legislation would treat net income, gain or loss with respect to applicable commodities¹ into account as UBTI to tax-exempt investors. In addition, the proposed legislation would require a tax-exempt organization to currently recognize its pro rata share of a foreign corporation’s income, gain or loss with respect to any applicable commodity unless such income, gain or loss was already subject to U.S. federal income tax (e.g., effectively connected income). Further, a tax-exempt organization would be required to recognize UBTI on a sale of stock of a foreign corporation that holds applicable commodities to the extent of gain or loss that is attributable to the foreign corporation’s unrecognized gain or loss with respect to applicable commodities.

TAXATION OF SALES AND EXCHANGES OF COMMODITIES BY U.S. PERSONS

Generally, gains and losses from the sale or exchange of commodities are taxed as capital gains or losses. Under present law, long-term capital gains recognized by individuals are subject to a preferred tax rate.

Under the proposed legislation, 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, without regard to the taxpayer’s holding period.² In addition, a sale or exchange of a partnership interest holding an applicable commodity would be treated as short-term capital gain or loss with respect to the portion attributable to the unrecognized gain or loss in the applicable commodity, provided the partner otherwise would not be required to treat the gain or loss as ordinary income or loss.

¹ For purposes of determining UBTI, “applicable commodities” is expanded to include section 1256 contracts that are required to be marked to market.

² The proposed legislation 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 section 475(f) of the Internal Revenue Code, (iv) a business that sells or exchanges an applicable commodity as part of a hedging transaction, as defined in section 1221(a)(7) of the Internal Revenue Code or (v) a person who regularly uses or consumes an applicable commodity in the ordinary course of such person’s trade or business.

TAXATION OF COMMODITIES DERIVATIVES

Gain or loss with respect to a commodity derivative that is a section 1256 contract subject to mark-to-market rules is generally characterized as long-term gain or loss and short-term gain or loss in a ratio of 60 percent and 40 percent, respectively (the “60/40 rule”). Gain or loss from the termination of a section 1256 contract is also generally subject to the 60/40 rule.

Under the proposed legislation, 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 subject to the 60/40 rule, is treated as 100 percent short-term capital gain or loss. The proposed legislation also contains certain anti-abuse provisions and provisions related to the carryback of certain losses.

ANALYSIS

This proposed legislation would impose particularly onerous tax consequences to persons trading in applicable commodities, particularly U.S. tax-exempt investors, U.S. individual investors with long-term holding period investment strategy and U.S. taxable investors trading section 1256 contracts. The bill raises a number of questions regarding its viability, including issues related to the administration and compliance issues arising from tax-exempt entities’ investment in foreign corporations holding any applicable commodities (for example, investment by U.S. tax-exempt investors in foreign publicly traded corporations with any exposure to applicable commodities) and a potential chilling effect on tax-exempt entities’ ability to invest in many types of offshore funds.

We understand from sources on Capitol Hill that support for this bill is currently limited to certain members of the Senate, where it is expected to be received with significant skepticism. It is our understanding that the bill was devised by its sponsors without any consultation with Senator Max Baucus, D-Mont., chairman of the Senate Finance Committee. It is our further understanding that Chairman Baucus intends to review the bill during the current congressional recess period, and is soliciting input from the public prior to Congress’ return to session in September. However, in light of the legislation’s bipartisan sponsors, Senator Grassley’s support (considering his position as ranking member of the Senate Finance Committee), the government’s need to generate revenue and the significant media and congressional attention directed at investors in oil and natural gas assets, we believe this legislation merits careful attention. As such, we will continue to monitor any developments relating to this or similar legislation on behalf of our clients.

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