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From:
Sent: Tuesday, April 20, 2010 10:34:09 AM
To:
Cc:
Subject: Failed Section 1221(a)(7) and Section 1256(e)(2) Hedge Identifications

Taxpayer is in the commodity X business, buying inventory, processing it and then selling such to customers. Taxpayer filed a refund claim for several back years in which it claims to have erroneously treated as capital the gains and losses originally reported from certain asserted hedging transactions.

The gains and losses arose from "price-to-be-fixed" (PTBF) supply contracts for commodity X and certain section 1256 contracts, exchange-traded options and futures with respect to commodity X. The PTBF supply contracts were agreements in which Taxpayer separately took delivery of commodity X that it recorded as inventory on its books at the current spot price. The final price, however, was not locked-in till later. Rather than report the difference between the spot price and the final locked-in price as an adjustment of its inventory accounting, Taxpayer accounted for any difference as capital gain or loss. Gains and losses on the PTBF supply contracts and the exchange-traded option and future contracts were recognized on a realization basis.

Faced with expiring capital losses, Taxpayer filed amended returns for back years seeking to recharacterize the gains and losses from the above transactions as ordinary. Taxpayer's position is that the gains and losses on the PTFB contracts are ordinary because those amounts arose from inventory purchases covered under section 1221(a)(1). Taxpayer further contends that it made a valid section 1221(a)(7) hedge identification of all of the above contracts and that it also validly identified the exchange-traded contracts as hedges under section 1256(e)(2). Finally, Taxpayer alternatively contends that its failure to timely identify the transactions as hedges under section 1221(a)(7) and section 1256(e)(2) is excusable under the inadvertent error rule of section 1.1221-2(g)(2)(ii).

Two years ago, during a separate audit partly covering the refund claim period, the Service issued an information document request that questioned the nature of Taxpayer's commodity X hedging. The auditor had highlighted that Taxpayer board of director minutes seemed to conflict with an initial audit interview in which Taxpayer claimed that the company did not hedge its commodity X inventory. The information document request also stated that the company had indicated that it had entered into

speculative transactions. In response to the detailed tax hedging related inquiries, Taxpayer generally provided the blanket response -- "No hedge accounting."

For now, we are only commenting on Taxpayer's hedging transaction contentions as we have just begun to coordinate the section 1221(a)(1) and associated accounting issues with . Consistent with your preliminary views, we find Taxpayer's claim for ordinary treatment based on the hedging rules to be without merit. Taxpayer's various hedge-related contentions are discussed below; additional facts are highlighted where relevant.

Claimed Hedge Identifications Under Sections 1221(a)(7) and 1256(e)(2)

Consistent with its ongoing treatment of gains and losses on the PTFB and exchange-traded contracts as capital, Taxpayer apparently concedes that there is nothing in its books and records specifically identifying the transactions as hedges for Federal income tax purposes. Rather, Taxpayer argues that certain non-tax specific public records are section 1221(a)(7) and section 1256(e)(2) identifications. In particular, Taxpayer argues that it clearly identified the transactions and claims that all of its PTBF and exchange-traded futures contracts were economically managing commodity X pricing risk.

Section 1221(a)(7) provides ordinary asset treatment for any hedging transaction which is clearly identified as such before the close of the day on which it is acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe). See also section 1.1221-2(f)(1) (containing hedge identification language that mirrors section 1221(a)(7)). Section 1.1221-2(f)(4)(i) requires that the identification be retained as part of the taxpayer's books and records. Further, the presence of the identification must be unambiguous. Section 1.1221-2(f)(4)(ii). The regulation further states that the identification of a hedging transaction for financial accounting or regulatory purposes is not unambiguous unless the books and records indicate the identification is also being made for tax purposes.

Nothing in the facts reviewed suggests Taxpayer satisfied the same day identification requirement or that hedge identifications were made for tax or any other purpose. The public statement that Taxpayer relies on does not mention tax or an identification of any type. It simply reports that Taxpayer will often hold a mix of exchange-traded contracts (options and futures) to hedge commodity X prices. By contrast, an annual report issued during the same time period states that Taxpayer acquired various derivatives as investments or as economic hedges but that the derivatives were not designated as accounting hedges. Taken together, the public documents establish that some but not all of Taxpayer's exchange-traded derivatives were entered into to economically hedge commodity X inventory, the PTFB contracts were not considered hedges, and Taxpayer did not even designate the exchange-traded derivatives as hedges for financial accounting purposes. Notably, there is nothing in the information reviewed that suggests that tax hedging identifications were intended or made – consistent with the treatment of the transactions in Taxpayer's originally filed returns and consistent with the fact that only some were regarded as economic hedges. Moreover, Taxpayer's

contention that it made valid identifications is further undermined by its claim, discussed below, that it was unaware of the tax hedge identification requirements and that it did not develop an identification practice.

Given that it is undisputed that the exchange-traded commodity X contracts were section 1256 contracts and capital assets in Taxpayer's hands, they were subject to section 1256 character treatment (60% long-term capital gain or loss and 40% short-term capital gain or loss) unless they were properly identified under section 1256(e)(2) as hedging transactions. Section 1256(e)(2) provides that the hedging identification must be clearly made before the close of the day on which the transaction was entered into (or such earlier time as the Secretary may prescribe by regulations). Under section 1.1256(e)-1(b), the hedging identification requirements of section 1.1221-2(f)(1) must be satisfied to be a valid section 1256(e)(2) identification. Given Taxpayer did not make timely and valid identifications under section 1.1221-2(f)(1), section 1256(e)(2) identifications were also not made.

Claimed Inadvertent Error

Generally, the absence of an identification that satisfies the requirements of section 1.1221-2(f)(1) will be binding to establish the transaction is not a hedging transaction. However, ordinary treatment of hedging transactions under section 1221(a)(7) is permitted under an inadvertent error exception. Under section 1.1221-2(g)(2)(ii), a taxpayer may treat as ordinary the gain or loss from a transaction that would otherwise qualify as a hedging transaction if generally the failure to identify the transaction was due to "inadvertent error" and all of the taxpayer's hedging transactions in all open years are being treated as ordinary. Notwithstanding Taxpayer's consistent and ongoing treatment of the PTFB and exchange-traded contracts as capital, it contends that its failure to timely identify the contracts was attributable to inadvertent error.

Not Applicable Under Section 1256

The bulk of the capital losses at issue arose from section 1256 exchange-traded contracts. Although the section 1256 regulations do not contain an inadvertent error exception, Taxpayer maintains that the section 1221 inadvertent error exception is incorporated into section 1256 so as to also excuse failed section 1256(e)(2) identifications. To make its argument, Taxpayer's simply misstates the language in the regulations.

The section 1256 regulations do not incorporate the section 1.1221-2(g)(2)(ii) inadvertent error exception for failed identifications, though they do pick up the separate inadvertent identification rule in section 1.1221-2(g)(1)(ii) so that inadvertently identified transactions are treated as not identified under section 1256(e)(2). See section 1.1256(e)-1(c).

Section 1.1256(e)-1(b) states that an identification of a hedging transaction for purposes of section 1256(e)(2) must satisfy the requirements of section 1.1221-2(f)(1). As

discussed above, section 1.1221-2(f)(1) requires timely and clear (unambiguous) identification. The section 1256 regulations go on to say that an identification under section 1.1221-2(f)(1) is considered an identification under section 1256(e)(2), but notably does not state that the inadvertent error exception of section 1221 excuses a failed identification under section 1256(e)(2). Further, section 1.1256(e)-1(b) provides that an identification that does not satisfy all of the requirements of section 1.1221-2(f)(1) is treated as identified under section 1256(e)(2) but only for the narrow purpose of applying section 1256(f)(1). (Taxpayer misstated this rule to apply much more broadly than to deny capital gains treatment as provided by section 1256(f)(1).)

There may be at least a couple reasons the section 1256 regulations do not pick up the section 1.1221-2(g)(2)(ii) inadvertent error rule. First, section 1221(b)(2)(B) instructs that the Secretary shall prescribe regulations to address the treatment of non-identified hedging transactions, whereas section 1256(e)(2) states that a hedging transaction must be clearly identified before the close of the day on which such transaction was entered into or such earlier time as the Secretary may prescribe by regulations. Apart from the narrower statutory language in section 1256, inadvertent error relief for failed section 1256(e)(2) identifications may have been thought undesirable because hedging transaction identification also determines whether a section 1256 contract is subject to section 1256(a)(1) mark-to-market accounting. Given the special hindsight concerns that exist with mark-to-market accounting, stricter identification procedures are especially warranted. Whatever the reason(s), however, Taxpayer has no legal basis for claiming that its failure to timely identify the section 1256 contracts as hedging transactions is cured by a claim of inadvertent error.

Factual Burden Not Satisfied

Since the PTFB contracts were not section 1256 contracts, Taxpayer's satisfaction of the inadvertent error exception could potentially excuse its failure to timely identify those transactions as hedges under section 1221. Taxpayer's argument is relatively straightforward – it argues that it was inadvertent error not to have identified the PTFB (and exchange-traded contracts) because it was unaware of the need to identify the transactions as hedges for Federal income tax purposes. Relying on Service letter rulings that suggest that the term "inadvertent" means "an accidental oversight or a result of carelessness," Taxpayer claims that it was accidental oversight not to apprize itself of the hedge identification rules. Taxpayer contends "no practice to identify or not identify was developed at all" but that if it had researched the law, the gains and losses would have been treated as ordinary. Though Taxpayer does not couch it as such, it argues, in essence, that "ignorance of the law" is excusable inadvertent error under section 1.1221-2(g)(2)(ii).

Even if the inadvertent error can legally excuse "ignorance of the law," we are not factually persuaded by Taxpayer's argument. In particular, we are not convinced that Taxpayer's non-identification was either "error" or "inadvertent."

As for being "error," the public statement relied upon by Taxpayer indicates that it only considered the exchange-traded contracts to be economic hedges, but did not consider the PTFB contracts as such. Further, Taxpayer's prior audit response that there was "No hedge accounting" is consistent with the information document request that repeats Taxpayer's statement in an initial interview that it did not hedge commodity X. Given that some of the contracts in question were for the purchase of inventory and others were made speculatively or as investments, it is difficult to accept Taxpayer's blanket contention that the arrangements would have qualified as hedging transactions for Federal income tax purposes. Stated otherwise, it seems fairly clear that Taxpayer did not make an error in not identifying many of the transactions as hedges as they were not primarily entered into to manage pricing risks. Section 1.1221-2(b)(1).

We also are not factually persuaded by Taxpayer's claim of "inadvertence." Taxpayer's more recent responses to information document requests state that it was aware of the ability to treat hedges as ordinary under the tax rules, but it made the decision not to further research such. In one response, it advised that it made the decision not to amend tax returns several years earlier (when it first became aware of the opportunity to treat hedges as ordinary) because of the cost and work involved. Though glossed over, Taxpayer continued to not identify the transactions as hedges even after the large losses several years ago and continued to treat gains and losses as capital. This neglect of the rules continued even after the Service raised detailed questions on audit regarding Taxpayer's hedging.

We are not in a position to challenge Taxpayer's assertion that it did not bother looking into the tax rules even after the large capital losses or after and as part of responding to the Service audit inquiry regarding hedging. However, we can confidently state that, at best, Taxpayer made the decision not to investigate further even after having at least a general appreciation that ordinary treatment might be available for tax hedges. As a factual matter, such a decision is not inadvertence. It is deliberate and conscious.

Based on the above, we do not see factual grounds for concluding that Taxpayer has satisfied its burden of proving either "error" or that it "inadvertently" failed to identify the PTFB or exchange-traded contracts as hedges.

Given the above should dispense with the Taxpayer's hedge arguments, it is not necessary to address as a legal matter at this time the question of whether and/or when "ignorance of the law" excuses a failure to identify under the section 1.1221-2(g)(2)(ii) "inadvertent error" rule. _

Additional Comments and Caveats

As discussed, we will continue to coordinate with on the section 1221(a)(1) issue, particularly given the potential inventory accounting and change in accounting method implications of Taxpayer's section 1221(a)(1) argument.

Based on facts provided to date, we would not assume or concede that: (a) Taxpayer entered into PTFB contracts or each exchange-traded commodity X contract primarily to manage pricing risks of inventory (i.e., as hedging transactions) or (b) Taxpayer was unaware of the tax hedging requirements -- particularly without at least examining relevant source documents (including public accounting firm and internal audit checklists).

Though presumably not at issue in examination of the refund claim, please be aware that section 1256(a)(1) requires mark-to-market accounting of the section 1256 contracts absent timely identification of those contracts as hedging transactions under section 1256(e)(2). Also, if evidence is produced to enable you to determine that any of the non-section 1256 contracts are section 1.1221-2(b) hedging transactions (even if not identified as such) or that some of the section 1256 contracts were timely and properly identified as hedging transactions, you may wish to touch base to discuss the section 1.446-4 hedge accounting rules which generally require a taxpayer to clearly reflect income by reasonably matching the timing of income, deduction, gain or loss from a hedging transaction with the timing of the income, deduction, gain or loss from the item or items hedged. Consistent with the carve out of section 1256 contracts from Rev. Rul. 2003-127 and the plain reading of the statutory language of section 1256, the section 1256(a)(1) mark-to-market accounting regime (and not the section 1.446-4 hedge accounting rules) applies to section 1256 contracts that are not timely and clearly identified under section 1256(e)(2) even if the contracts would have otherwise constituted qualifying hedging transactions if timely and properly identified.

Thanks for contacting us on this and hope this helps with your disposition of this matter.