

Dear _____ :

This is in response to your letter, dated X, requesting that the source of gain or loss on hedging transactions entered into by Taxpayer be determined by reference to the source of gain or loss derived from the sale of inventory property owned by Taxpayer that is hedged by the hedging transactions.

FACTS

Parent was incorporated in State A and is headquartered in State B. Taxpayer is on the accrual method of accounting and files a consolidated U.S. federal income tax return pursuant to section 1502 of the Internal Revenue Code of 1986, as amended (the "Code"). Taxpayer's taxable year is the calendar year.

Taxpayer operates across the entire spectrum of the Business. The Business's manufacturing and production sites are often located in different locations than the markets for the resulting resources and products. Taxpayer sells its manufactured products to third parties and related, unconsolidated parties for consumption or further processing. Taxpayer purchases the Inputs for manufacturing within its own plants where either internal production is insufficient or transportation or other logistics dictate for efficiency. Taxpayer also purchases finished products from third parties for subsequent sale to Taxpayer's customers. In the normal course of its business, Taxpayer executes thousands of sale and exchange transactions of physical inventory property during its taxable year.

Taxpayer trades commodity derivatives, including futures contracts and options contracts (the "Commodity Derivatives") in the normal course of its business, to ensure operational predictability by managing price risk associated with its inventory property due to external influences, including weather and natural disasters, geopolitical events, and facility maintenance. Two members of Taxpayer's U.S. tax consolidated group trade the Commodity Derivatives. Affiliate 1, which only has a trading office in the United States, conducts trading operations for the Inputs and products produced and sold within the United States. Affiliate 2, which has a trading office in the United States and another trading office in _____, purchases and sells certain Inputs and products primarily internationally, but also within the United States in certain circumstances. Affiliate 1 and Affiliate 2 purchase and sell the Commodity Derivatives on the Regulated Exchanges. The Regulated Exchanges match either Affiliate 1 or Affiliate 2, as the case may be, with counterparties to the Commodity Derivatives. Affiliate 1 and Affiliate 2 primarily manage risk associated with their own business activities, but to limit the relationships with external brokerages that Taxpayer must manage, they also manage price exposure of other U.S. tax consolidated members. Taxpayer does not hedge the risk associated with inventory property of any of its affiliates that are not members of Taxpayer's U.S. tax consolidated group.

Taxpayer uses data processing systems to identify qualified hedging transactions. When a derivatives trader executes a hedging transaction, Taxpayer's data processing systems capture and record data for that trade. Taxpayer's data processing systems specifically record the related physical trade, trade item, commodity type, deal type, dates, and pricing information, which includes the currency and the calendar month in which the derivative expires. When a hedging transaction is entered into Taxpayer's data processing systems, it is assigned a strategy number that specifically links the hedging transaction to the underlying physical inventory/commodity. Accordingly, the amount, nature of the commodity, and location of the physical commodity is identified and recorded for each trade.

Taxpayer represents that (1) the Commodity Derivatives qualify as "hedging transactions" within the meaning of section 1221(b)(2)(A) and Treas. Reg. § 1.1221-2(b), (2) it satisfies the identification requirements in section 1221(a)(7) and Treas. Reg. § 1.1221-2(f) with respect to the Commodity Derivatives, and (3) the Commodity Derivatives hedge property that qualifies as "inventory property" under section 865(i)(1).

Since Taxpayer has reported gain or loss on the Commodity Derivatives for U.S. federal income tax purposes by reference to the source of gain or loss derived from the sale of inventory property owned by Taxpayer that is hedged by the Commodity Derivatives,¹ Taxpayer represents that it has taken this tax reporting position because applying section 865(a) to the Commodity Derivatives results in mismatched sourcing among gain or loss on the Commodity Derivatives and gain or loss derived from the sale of inventory property owned by Taxpayer that is hedged by the Commodity Derivatives.

Taxpayer has requested a ruling that the source of gain or loss on the Commodity Derivatives is determined by reference to the source of gain or loss derived from the sale of inventory property owned by Taxpayer that is hedged by the Commodity Derivatives.

LAW

Section 865 sets forth rules to source sales of personal property. Under section 865(a), income from a sale of personal property is generally sourced based on the residence of the seller. Special rules apply, however, with respect to certain property, including inventory property. Section 865(b) sources income derived from the sale of inventory property by reference to sections 861(a)(6), 862(a)(6), and 863. Under sections 861(a)(6) and 862(a)(6), purchased inventory property is sourced based on the place of the sale or exchange of the inventory property. Under section 863, produced inventory property is sourced based on the location of the production activities. Treas. Reg. § 1.865-1 sets forth rules for losses with respect to personal property other than

¹ Taxpayer sources net gain or loss on the Commodity Derivatives associated with aggregate risks by apportioning between U.S. and foreign source in the same proportion as the gross receipts derived from the sale of the inventory property.

stock. Treas. Reg. § 1.865-1(c)(1) states, however, that this section does not apply to loss recognized with respect to options contracts or derivative financial instruments, including futures contracts, forward contracts, notional principal contracts, or evidence of an interest in any of the foregoing.

Section 865(i)(1) states that the term “inventory property” means personal property described in section 1221(a)(1). Section 1221(a)(1) provides that the term “capital asset” does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Section 865(j)(2) directs the Department of the Treasury to prescribe regulations as may be necessary or appropriate to carry out the purpose of section 865, including regulations applying the rules of section 865 to income derived from trading in futures contracts, forward contracts, options contracts, and other instruments. See *also* S. REPT. NO. 99-313, 99th Cong., 2d Sess., 333 (1986) (generally restating the same). The Department of the Treasury has not yet prescribed regulations pursuant to section 865(j)(2).

The Code does not provide a specific sourcing rule for futures contracts and options contracts. In light of the absence of specific sourcing rules for futures contracts and options contracts and the absence of regulations pursuant to section 865(j)(2), the source of income from trading in futures contracts and options contracts may be determined by analogy. Bank of Am. v. United States, 680 F.2d 142, 147 (Ct. Cl. June 2, 1982) (“When an item of income is not classified within the confines of the statutory scheme nor by regulation, courts have sourced the item by comparison and analogy with classes of income specified within the statutes.”); see also Container Corp. v. Commissioner, 134 T.C. 122, 131 (2010) (“[I]f a category of FDAP is not listed [in the sourcing rules], caselaw tells us to proceed by analogy.”); Howkins v. Commissioner, 49 T.C. 689, 695 (1968) (“[I]n the absence of a specific statutory source-of-income rule for alimony, the statutory rules of general application, and especially the general rule for interest payments, present a persuasive analogy.”). Section 865(a) is one possible analogy for sourcing income from trading in futures contracts and options contracts. See JOINT COMMITTEE ON TAXATION, “Present Law and Issues Related to the Taxation of Financial Instruments and Products,” JCX-56-11, at 78 (Dec. 2, 2011). Another possible analogy is the inventory sourcing rules. Id. at 79 (“In [the] case [of a U.S. taxpayer that is an oil company trying to hedge its risk], the oil futures contract may be more analogous to inventory such that the source of income from cash settlement should be determined under the inventory property sales source rule, which is where the title to inventory property is passed.”).²

² Note that the rule for sourcing produced inventory has changed since the publication of this JCT report. Produced inventory property now is sourced based on the location of the production activities. Section 863.

The Supreme Court has addressed the treatment of hedging transactions for purposes of determining whether an asset is capital or ordinary. Hedging transactions that are an integral part of a business' inventory purchase system are treated as ordinary, not capital, assets. Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 50 (1955); Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 222 (1988). The Supreme Court, in Arkansas Best, clarified Corn Products Refining, which held that commodity futures transactions that were an integral part of the petitioner's own business designed to protect it against a price increase in principal raw material and to assure a ready supply for future manufacturing requirements are taxable as ordinary income, rather than capital gains. Corn Products Refining, 350 U.S. at 50.³ In Arkansas Best, the petitioner relied on Corn Products Refining to argue that assets acquired and sold for ordinary business purposes rather than for investment purposes should be given ordinary asset treatment. Arkansas Best, 485 U.S. at 216. The Supreme Court, in Arkansas Best, disagreed with the petitioner's expansive interpretation of Corn Products Refining. Instead, the Supreme Court explained that the close connection between the commodity futures transactions and the petitioner's business in Corn Products Refining was crucial to whether the commodity futures transactions should be considered surrogates for the petitioner's stored inventory. Id. at 222.

In addition to matched character treatment, the timing of taking into account gain or loss on a hedging transaction generally matches the timing of taking into account gain or loss derived from the sale of the inventory property that is hedged. See Treas. Reg. § 1.446-4(e)(3).

Section 1221(a)(7) provides that the term "capital asset" does not include any hedging transaction which is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe).

Treas. Reg. § 1.1221-2 governs the treatment of hedging transactions under section 1221(a)(7). Treas. Reg. § 1.1221-2(b) defines a "hedging transaction" as any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily (1) to manage risk of price changes or currency fluctuations with respect to ordinary property (as defined in Treas. Reg. § 1.1221-2(c)(2)) that is held or to be held by the taxpayer; (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or (3) to manage such other risks as the Secretary may prescribe in regulations. See also section 1221(b)(2)(A) (providing the same definition of a "hedging transaction"). Treas. Reg. § 1.1221-2(c)(3) provides that the term hedging transaction includes a transaction that manages an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only

³ Section 1221(a)(7) supersedes the holdings in Arkansas Best and Corn Products Refining for purposes of determining character of hedging transactions, but the rationale of these cases is relevant for purposes of sourcing hedging transactions.

if all of the risk, or all but a de minimis amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings. Treas. Reg. § 1.1221-2(e) provides that the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation.

Treas. Reg. § 1.1221-2(f) provides specific rules for identification and recordkeeping of hedging transactions. Treas. Reg. § 1.1221-2(f)(1) requires that, under section 1221(a)(7), a taxpayer that enters into a hedging transaction (including recycling an existing hedging transaction) must clearly identify the hedging transaction as a hedging transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction (or recycled the existing hedging transaction).

ANALYSIS

There is not a rule that expressly addresses how to source gain or loss on the Commodity Derivatives. Furthermore, the Department of the Treasury has not yet prescribed regulations pursuant to section 865(j)(2) applying the rules of section 865 to income derived from trading in futures contracts or options contracts. Therefore, the source of gain or loss on the Commodity Derivatives is determined by analogy to a statutory sourcing rule. Bank of Am., 680 F.2d at 147. Pursuant to section 865(b), income derived from the sale of inventory property that Taxpayer owns is sourced under sections 861(a)(6) and 862(a)(6) based on the place of the sale or exchange of the inventory property or under section 863 based on the location of Taxpayer's production activities. Gain or loss on the sale of personal property is sourced under section 865(a) based on Taxpayer's residence.

When courts source income by analogy, they look to the substance of the transaction in question. Bank of Am., 680 F.2d at 147. If Taxpayer were to source gain or loss on the Commodity Derivatives under section 865(a) based on Taxpayer's residence, the gain or loss on the Commodity Derivatives would always be U.S. source, while the gain or loss derived from the sale of Taxpayer's inventory property would be either U.S. source or foreign source depending on the place of the sale or exchange of the inventory property or the location of Taxpayer's production activities. Therefore, sourcing gain or loss on the Commodity Derivatives under section 865(a) could be inconsistent with the substance of the transactions as hedges of the underlying inventory property.

Taxpayer sources gain or loss on the Commodity Derivatives by reference to the source of gain or loss derived from the sale of inventory property owned by Taxpayer that is hedged by the Commodity Derivatives. Sourcing in this manner is appropriate if it is consistent with the substance of the transactions as hedges. The rationale of Corn Products Refining is useful in this regard. By referring to section 1221(a)(1) to define "inventory property" in section 865(i)(1), Congress imported the principles of Corn Products Refining to section 865. See, e.g., Merck & Co., Inc. v. Reynolds, 559 U.S.

633, 648 (2010) (“We normally assume that, when Congress enacts statutes, it is aware of relevant judicial precedent.”).⁴

The petitioner in Corn Products Refining traded commodity futures contracts to protect it against a price increase in principal raw material and to assure a ready supply for future manufacturing requirements. The Supreme Court held that petitioner’s commodity futures contracts were an integral part of its business and, therefore, were to be treated as the hedged inventory property and taxable as ordinary income, rather than capital gains. Similar to the petitioner in Corn Products Refining, Taxpayer trades the Commodity Derivatives to purchase and sell raw materials within certain pricing parameters to ensure operational predictability. Therefore, sourcing gain or loss on the Commodity Derivatives by analogy to the inventory sourcing rules applicable to the hedged property more appropriately reflects the substance of the transactions as hedges of the underlying inventory property.

RULING

Based solely on the information submitted and the representations made, the source of gain or loss on the Commodity Derivatives is determined by reference to the source of gain or loss derived from the sale of that particular inventory property owned by Taxpayer for which the Commodity Derivatives have been identified as a hedging transaction under section 1221(a)(7) and Treas. Reg. § 1.1221-2(f).

CAVEATS

The ruling contained in this letter is based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the ruling request, and it is subject to verification on examination.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

⁴ Applying the principles of Corn Products Refining and Arkansas Best to give meaning to section 865(j)(2) under the rationale of International Multifoods, however, is too attenuated. International Multifoods Corp. v. Commissioner, 108 T.C. 579 (1997) (holding that section 865(j)(1) should be given effect because its legislative history demonstrates that Congress intended to change the sourcing rules for losses realized on the sale of noninventory personal property). The lack of a clear legislative purpose behind section 865(j)(2), as compared to the legislative purpose behind section 865(j)(1) that was articulated in legislative history, distinguishes it from the reasoning applied to section 865(j)(1) in International Multifoods.

A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

D. Peter Merkel
Chief, Branch 5
Office of the Associate Chief Counsel
(International)

cc: