DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Application of I.R.C. § 1256(f)

This Field Service Advice responds to your memorandum dated October 12, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer	=
Corporation	=
Marketing Affiliate	=
$A	=
B	=
$C	=
Year 1	=
Year 2	=
Date 1	=

ISSUES

1. Whether I.R.C. § 1256(f)(2) permits Taxpayer to claim ordinary gains or losses on futures contracts that do not constitute hedging transactions, either under I.R.C. § 1256(e) or Treas. Reg. § 1.1221-2(b).

2. Whether I.R.C. § 1256(f)(1) precludes capital gains treatment for certain of Taxpayer's transactions.

CONCLUSIONS

1. Based on the facts provided, Taxpayer may not treat gains or losses on its future contracts as ordinary under I.R.C. § 1256(f)(2). As the contracts do not meet the definition of hedging transactions, I.R.C. § 1256(a)(3) provides for capital treatment of the gains and losses.

2. If Taxpayer identified the transactions for tax purposes as hedging transactions, I.R.C. § 1256(f)(1) may preclude treating any gain on those transactions as capital. Despite the denial of capital gains treatment, however, any losses would still be treated as capital.

FACTS

Taxpayer is the common parent of an affiliated group that files a consolidated federal income tax return. During Year 1 and Year 2, Taxpayer owned a majority of the outstanding stock of Corporation. Corporation's business included the domestic exploration for and development, production and marketing of natural gas and crude oil. Marketing Affiliate, a wholly-owned subsidiary of Corporation, was responsible for the natural gas marketing.

During the years in issue, Corporation entered into long futures contracts in natural gas, either on behalf of Marketing Affiliate or to acquire physical gas supplies. At the end of Year 1, all open positions on long future contracts held by Corporation were marked to market, but gains and losses were treated as ordinary. Taxpayer states that the positions could not be treated as hedges for tax purposes. On its Year 1 tax return, Taxpayer reported as ordinary income a net gain of $A.

As of Date 1, Corporation stopped acquiring long positions on Marketing Affiliate's behalf. There were B long futures contracts open at the end of Year 2. These positions were not marked to market and any gain or loss was deferred and treated as part of a hedge transaction for financial purposes. All positions were booked at one account and treated as ordinary gain or loss. For Year 2, Taxpayer reported a $C ordinary loss resulting from the long futures positions Corporation entered into on Marketing Affiliate's behalf.

After an examination of Taxpayer, the Internal Revenue Service (the "Service") adjusted the amounts reported in connection with the futures contracts from ordinary gains and losses to capital gains and losses. Taxpayer apparently agrees that the transactions were not hedges for federal tax purposes as the long futures positions were acquired by Corporation, but reduced the price risk of its affiliate. Taxpayer did not make a retroactive single-entity election for the years in issue.

LAW AND ANALYSIS

1. I.R.C. § 1256(f)(2)

Gains and losses on futures contracts are generally treated as capital under section 1221 of the Internal Revenue Code. Under Treas. Reg. § 1.1221-2(a)(1), however, property that is part of a hedging transaction, as defined in paragraph (b) of that section, is not a capital asset. If a transaction is not a hedging transaction, gain or loss from the transaction is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose. Treas. Reg. § 1.1221-2(a)(3).

Pursuant to section 1256(b), regulated futures contracts are included in the definition of "section 1256 contracts."[1] Under section 1256(a)(1), each section 1256 contract held by the taxpayer at the close of the taxable year shall be treated as sold for its fair market value on the last business day of such taxable year and any gain or loss shall be taken into account for the taxable year. Section 1256(a)(3) provides that any gain or loss with respect to a section 1256 contract shall be treated as short-term capital gain or loss, to the extent of 40 percent of such gain or loss, and long-term capital gain or loss, to the extent of 60 percent of such gain or loss. However, section 1256(f)(2) provides that paragraph (3) of subsection (a) shall not apply to any gain or loss which, but for such paragraph, would be ordinary income or loss.

Pursuant to section 1256(e)(1), the mark to market rules of subsection (a) shall not apply in the case of a hedging transaction. For purposes of section 1256(e)(2), the term "hedging transaction" means any transaction if –

> (A) such transaction is entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily-
>
> > (i) to reduce risk of price change or currency fluctuations with respect to property which is held or to be held by the taxpayer, or
> >
> > (ii) to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer,

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[1] See Greene v. United States, 185 F.3d 67 (2d Cir. 1999) (Section 1256 was meant to apply broadly to all futures contracts unless specifically excepted).

(B) the gain or loss on such transactions is treated as ordinary income or loss, and

(C) before the close of the day on which such transaction was entered into (or such earlier time as the Secretary may prescribe by regulations), the taxpayer must clearly identify such transaction as being a hedging transaction.

Apparently, there is no dispute that the transactions at issue do not meet the definition of hedging transactions under section 1256(e). Rather, Taxpayer contends that section 1256(f)(2) permits the gains and losses on the transactions to be treated as ordinary. Specifically, Taxpayer asserts that Corporation entered into the futures contracts at the direction of Marketing Affiliate for one of two purposes: (1) as a means of managing the price risk on Marketing Affiliate's purchases and sales of natural gas inventory or (2) to acquire natural gas inventory for resale to Marketing Affiliate. Thus, Taxpayer asserts that the futures contracts are integrally related to inventory management, both for its own and its affiliate's inventory and are ordinary property in Taxpayer's hands under Corn Products Refining Company v. Commissioner, 350 U.S. 46 (1955) and Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988).

In Corn Products, the Supreme Court considered whether the taxpayer's purchases and sales of certain corn futures, that were in the nature of hedges, resulted in ordinary gain or loss, or in capital gain or loss. In that case, the taxpayer, a manufacturer of products derived from corn, purchased corn futures in order to protect itself again an increase in the price of corn, its major raw material. Although the futures transactions did not fall within the literal language of the exclusions to the definition of a capital asset found in section 117 (now section 1221) of the Code, the Supreme Court held that any gains or losses that the taxpayer sustained in its futures transactions were ordinary rather than capital gains or losses. The Court held, based on the legislative history of section 117, that Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary rather than as capital. 350 U.S. at 51-53. Accordingly, because the corn futures transactions constituted an integral part of the taxpayer's business, the Court held that any gains or losses resulting from such transactions are ordinary. Id.

In Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988), the Supreme Court made it clear that the classes of property listed as exceptions to capital asset treatment in section 1221 are exclusive. In that case, the Court addressed whether the disposition of bank stock by the taxpayer, which had been acquired with the purpose of preventing damage to its business reputation, resulted in capital loss. The taxpayer argued, conceding that the statutory exceptions did not apply, that its disposition of the stock was covered by the doctrine arising from Corn Products, in which, so the taxpayer asserted, the Supreme Court had carved out a nonstatutory exception whereby property acquired and held with a business purpose qualified as a noncapital asset. In Arkansas Best Corp., the Court concluded that a taxpayer's motivation in purchasing an asset is irrelevant to the question whether the asset is property held by a taxpayer (whether or not connected with his business). 485 U.S. at 223. The Court concluded that Corn Products stands for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of section 1221. Id. At 222.

2. I.R.C. § 1256(f)(1)

Section 1256(f)(1) denies capital gains treatment for property identified as part of a hedging transaction. Specifically, the cited section provides that gain from any property shall in no event be considered as gain from the sale or exchange of a capital asset if such property was at any time personal property (as defined in section 1092(d)(1))[2] identified under subsection (e)(2)(C) by the taxpayer as being part of a hedging transaction. The effect of this "whipsaw" under section 1256(f)(1) is that if a taxpayer identifies a position in personal property as part of a section 1256(e) hedging transaction, and if that transaction in retrospect does not constitute a hedging transaction, the taxpayer's gain (but not loss) on the hedge nonetheless will be treated as ordinary income.

Treas. Reg. § 1.1221-2(e)(1) provides that a taxpayer that enters into a hedging transaction must identify it as a hedging transaction. This identification must be made before the close of the day on which the taxpayer enters into the transaction. Further, a taxpayer that enters into a hedging transaction must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates. Treas. Reg. § 1.1221-2(e)(1).

Moreover, the identification required by the regulations must be made on, and retained as part of, the taxpayer's books and records. Treas. Reg. § 1.1221-2(e)(4). The presence or absence of an identification must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. Treas. Reg. §

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[2] Section 1092(d)(1) defines personal property as any personal property of a type which is actively traded.

1.1221-2(e)(4)(ii) further provides that the taxpayer may indicate that individual hedging transactions, or a class or classes of hedging transactions, that are identified for financial accounting or regulatory purposes are also being identified as hedging transactions for purposes of the regulation.

The identification of a hedging transaction for purposes of section 1256(e)(2)(C) must satisfy the requirements of Treas. Reg. § 1.1221-2(e)(1). Solely, for purposes of section 1256(f)(1), however, an identification that does not satisfy all of the requirements of section 1.1221-2(e)(1) is nevertheless treated as an identification under section 1256(e)(2)(C). Treas. Reg. § 1.1256(e)(1)(b).

In the instant case, Taxpayer apparently treated the futures contracts entered into in Year 2 as hedges for financial purposes. If Taxpayer's books and records unambiguously indicate that the transactions were also identified as hedges for tax purposes, section 1256(f)(1) may be applicable.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Based on the facts provided, Taxpayer's reliance on the cited cases is misplaced. Your memorandum indicates, and Taxpayer apparently concedes, that Corporation entered the futures contracts primarily on behalf of Marketing Affiliate and do not satisfy the definition of hedging transactions. Since there is no indication that the futures contracts were an integral part of Taxpayer's inventory purchase system and the transactions are not hedging transactions, Corn Products and Arkansas Best Corp. are inapplicable.

Further, as the transactions do not meet the definition of hedging transactions, the regulations preclude the treatment of gain or loss on the transactions as ordinary. Under Treas. Reg. § 1.1221-2(b), a transaction is a hedging transaction only if (among other things) the transaction is entered into primarily to reduce the taxpayer's risk. In the instant case, the transactions apparently reduced the risk of members of Taxpayer's consolidated group. Treas. Reg. § 1.1221-2(a)(3) precludes the treatment of gain or loss on the transactions as ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

Under current regulations, 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. For example, if any member of a consolidated group hedges the risk of another member of the group by entering into a transaction with a third party, that transaction may potentially qualify as a hedging transaction. Treas. Reg. § 1.1221-2(d)(1). This single-entity approach applies only to transactions entered into on or after March 8, 1996. However, a consolidated group may elect to apply the single-entity approach retroactively to all transactions entered into in any tax year beginning prior to March 8, 1996. Treas. Reg. § 1.1221-2(g)(5); Rev. Proc. 96-21, 1996-1 C.B. 660.

In the present case, the transactions at issue were entered into prior to March 8, 1996. Taxpayer followed the single-entity approach for all transactions entered into after March 8, 1996, but did not make a retroactive election for the transactions in issue. Accordingly, the single-entity approach under the current regulations is not applicable to the instant case.

Based on the information provided, there appear to be minimal hazards to litigating the position that the transactions in issue did not constitute hedging transactions for purposes of section 1256(e) or Treas. Reg. § 1.1221-2(a). In fact, Taxpayer apparently concedes this point. The principle that gain or loss on a futures contract that is not a hedging transaction is treated as capital is also fairly well settled.

That stated, prior to making a final determination, we believe it is necessary [redacted]

Further, [redacted] As stated, Rev. Proc. 96-21, 1996-1 C.B. 660 sets forth the manner in which a taxpayer may make a retroactive election. It is unclear from the information provided whether Taxpayer choose not to make a retroactive election that would apply to the transactions at issue or attempted to make such an election and was denied retroactive relief. If additional facts are made available with respect to this point, we will provide any assistance you may require in determining whether Taxpayer may be entitled to retroactive application of the single-entity rule.

[redacted]

[redacted]

Please call if you have any further questions.

By: JOEL E. HELKE
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