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From:
Sent: Tuesday, June 09, 2009 3:00:20 PM
To:
Cc:
Subject: Hedge Timing Proposed Adjustment

Taxpayer entered into a collar transaction (involving a series of puts and calls) which you believe was designed to manage pricing risks associated with its inventory sales. Though not identified as such, Taxpayer later claimed that the puts that it acquired were hedging transactions under section 1221, but it contends that the calls were not hedges. You are currently assisting Exam with the audit and evaluation of the call options, including whether they were hedging transactions. You have also generally inquired regarding Taxpayer's tax accounting treatment of the call options. For purposes of this email, it is assumed that facts will show the calls were qualifying section 1221 hedges but for Taxpayer's failure to identify them as hedges.

As discussed, the Service position is that non-section 1256 transactions that otherwise qualify as hedges under section 1221 must be accounted for under the hedge timing rules of section 1.446-4. Rev. Rul. 2003-127. The hedge timing rules were generally promulgated to preclude taxpayers from selectively recognizing built-in losses on hedges, which like straddles economically offset other taxpayer positions. In addressing loss selectivity concerns in the preamble to the Notice of Proposed Rulemaking for the hedge timing rules, the Service stated that, "Although flexibility to control the timing of gain or loss generally is accepted in the tax law, that flexibility is inappropriate when the transaction is so closely related to the asset or liability being hedged." 1993-2 C.B. 615, 616. The hedge timing rules generally require a taxpayer to reasonably match income, deduction, gain or loss on a hedge to the income, deduction, gain or loss on the underlying hedged items. Section 1.446-4(b).

Here, Taxpayer hedged its future inventory sales. Taxpayer's call options were European-style options with specified exercise and delivery dates extending out several years or more; thus, gain or loss on the hedge contracts could be readily matched to the inventory sales in a taxable period for which each hedge was intended to adjust pricing risk. If physical deliveries were made under the call contracts, then the premium associated with such deliveries should be included in sales proceeds so as to produce a reasonable matching. However, if the call options were cash settled, gain or loss on the options should be spread to and matched with the income generated from inventory sales in the period that the hedge contracts were designed to manage pricing risk, i.e., the taxable period in which delivery was specified in the hedge contract. See generally section 1.446-4(e)(3). Thus, your proposal to allocate gain or loss from any cash settled

calls consistent with future delivery dates for the European-style options should produce reasonable matching.

Even if Taxpayer did not comply with section 1.446-4(d), it may seek to argue that its use of realization accounting is permitted by section 1.446-4(e)(3). That provision states that other simpler, less precise methods may be used in appropriate cases where the clear reflection requirement of section 1.446-4(b) is satisfied. Section 1.446-4(e)(3)(ii)(A) provides for example that taking into account realized gains and losses on hedges of inventory sales when they would be taken into account if the gains and losses were elements of inventory cost in the period realized may clearly reflect income in some situations, but does not clearly reflect income for a taxpayer that uses the last-in, first-out method of accounting for its inventory. Given Taxpayer uses the first-in, first-out method, it is not expressly precluded from using a simpler realization method. However, Taxpayer would still have to show that its method clearly reflects income and produces reasonable matching. Section 1.446-4(e)(3)(ii). Had the calls in question been of short duration and inventory turned over rapidly, we suspect that Taxpayer could reasonably argue that realization treatment produces a reasonable match as minimal would be gained from requiring more precise accounting and Taxpayer's ability to gain advantage from selectively recognizing losses would be inherently constrained. Here, however, the fact that the calls in question generally ran for several years or longer makes such an argument quite difficult.

Your circumstances are complicated by the fact that Taxpayer modified the call options prior to their cash settlement.

All facts and circumstances need to be considered in determining whether the other agreements were materially different so that section 1001 gain or loss was triggered. The fact that the replacement calls were held by different dealers would normally not be considered significant. Further, the fact that some or all of the calls were altered so as to include a fair market value delivery feature (together with the call rights at the original or slightly varied prices) would not seem to be significant in an of itself given that the property involved was fungible and actively traded. Moreover, from a practical standpoint, there should be little or no consequence to determining whether a section 1001 event occurred for those contracts that continued to call for delivery of inventory during the same taxable period because any gain or loss on the original and replacement contracts should be spread to the same periods under the section 1.446-4 matching rules.

Also, please feel free to contact us for further assistance on any related matters including any issues associated with whether the contracts were qualifying hedging transactions. No opinion is expressed herein on the potential application of the straddle rules, section 475(e) or (f) or any other matter not expressly addressed. Obviously much of this advice is being provided without benefit of Taxpayer's analysis, so we would be happy to provide further thoughts as this matter develops and insights are gained on Taxpayer's views.