Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: April 26, 2011

to: Associate Area Counsel (Dallas Group1)
(Large Business & International)

from: Associate Chief Counsel
(Financial Institutions & Products)

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subject: Energy Company- Application of Section 475(e)

This Chief Counsel Advice responds to your request for assistance as to whether the Taxpayer properly applied mark-to-market treatment under section 475(e) to certain portions of a certain contractual Agreement. We are generally in agreement with your conclusions and analysis in the incoming request, and as such, we are only focusing our analysis on areas where we have some differences or those areas which may require further development. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
A =
B =
Agreement =
Section a =
Section b =
Section c =
Section d =
Section e =
Section f =
Subsection(1) =
Subsection (2) =
Section g =
Section h =
Section i =

Contract A =
Contract B =
X =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
Location 1 =
Lake =
Unit A =
Unit B =
Mine =
Station =
Fuel source A =
Operation A =
Smelter =
C Amount =
D Amount =
E Amount =
F Amount =
G Amount =
H Amount =
I Amount =
J Amount =
K Amount =
L Amount =
M Amount =
N Amount =
O Amount =
P Amount =
Q Amount =
R Amount =
w Months =
y years =

z =

ISSUES

1. Whether the Taxpayer, an energy company engaged in electricity generation operations and retail electricity sales, is a dealer in commodities for purposes of section 475?

2. Whether the Taxpayer's Agreement with X, or certain components thereof represents a commodity or evidence of an interest in a commodity for purposes of section 475?

3. Whether the Taxpayer's treatment of the Agreement clearly reflects the Taxpayer's income within the meaning of section 446?

4. Whether the Taxpayer's capacity to produce electricity (including, the power plants, fuel, coal, water, workforce in place, license, etc.) represents an offsetting position to the Agreement within the meaning of section 1092 such that Taxpayer's loss on the Agreement is limited to the amount of the loss that exceeds the unrecognized gain on the capacity of Unit B?

CONCLUSIONS

1. We are not yet convinced by your argument that the Taxpayer is not a dealer in commodities under section 475(e). We do agree that Taxpayer is not a dealer in commodities because of its activities under the Agreement. That seemed to be the basis for your conclusion. But that contract is not the only item that should be considered in determining whether Taxpayer is a dealer in commodities. We think that this issue may need some additional development as to whether Taxpayer's activities with the gas retail contracts make it a dealer. We also think determinations should be made as to whether Taxpayer regularly sold electricity to customers in the ordinary course of its business outside of its contract with X. The Agreement provided that it had that ability to do so. These activities could also qualify it as a dealer in commodities.

2. We agree with your conclusion that the Agreement is not a commodity as defined in section 475(e) (2), even if Taxpayer is considered a dealer in commodities.

3. We agree with your conclusion that Taxpayer's mark-to-market treatment of the Agreement fails to clearly reflect income.

4. We also agree with your conclusion that an argument should be made that Taxpayer's capacity in Unit B is an offsetting position to the Agreement and the

rules under section 1092 apply, limiting loss to amount of loss that exceeds unrecognized gain.

FACTS

The Taxpayer is an energy company.[1] The Taxpayer's principal business activities as disclosed on its Year 3 and Year 4 tax returns, the relevant years at issue, are electricity generation and retail sales. For the tax years at issue, Taxpayer is a U.S. partnership for federal income tax purposes.

Taxpayer, pursuant to the automatic consent provisions of Rev. Proc 2002-9, elected to be a dealer in commodities starting in Year 3. Taxpayer attached a statement to its Year 2 Form 8736-Application for Automatic Extension, filed on Date 1. The election statement provided that taxpayer "elects under IRC Section 475(e) to be treated as a commodity dealer with respect to its trading of financial and physical commodities (as that termed is defined in section 475(e) (2))." On Date 2, Taxpayer filed its Form 3115, Application for Change in Accounting Method, requesting permission to change from its accrual method to the mark-to-market method required for electing dealers under section 475(e). Automatic consent was granted pursuant to Rev. Proc 2002-9. In the Form 3115, Taxpayer represented that it had different trades and businesses and that it was a dealer in commodities, that it sold electricity to related and unrelated parties, as well as to retail customers in its service territory.

Since Date 3, Taxpayer, its predecessors, and successors have, pursuant to various written agreements, contracted to sell to X. and its predecessors, electricity that X uses to power its Operation A near Location 1. To ensure a source of electricity for its smelter, X planned to construct a power generating station near its smelter. Although X was willing to build the plant, it did not want to operate the plant itself. As a result, X and a predecessor to Taxpayer, A, entered into an Operating Contract in Date 3 whereby Taxpayer agreed contractually to operate X's Fuel Source A powered generating station at Location 1. This station later became known as the Unit A.

To ensure delivery of electricity to X's smelter, X and Taxpayer also entered into a Power Contract in Date 3. Essentially, the Power Contract required Taxpayer to build certain transmission lines and to provide electricity to power X's smelter operations and allowed Taxpayer to sell certain excess power over and above the power used for the smelter. Under the Date 3 contracts, X also acquired certain Fuel Source A reserves and mining assets from Taxpayer, which gave X the right to mine the Fuel Source A that would fuel the power generating station. As a result, X developed and owned what came to be known as Mine. Accordingly, X owned Unit A and Mine, but the Taxpayer and its successors operated both facilities under the Date 3 contracts.

Previous Arrangements and the Current Agreement

[1] A is the predecessor to Taxpayer and B is the successor to the Taxpayer. The term Taxpayer refers to the appropriate entity, depending upon the relevant time period.

Original Agreement (Date 4)

In Date 4, X and Taxpayer negotiated a contract related to a fourth electric plant, to be called Unit B. The original agreement obligated Taxpayer to build, own and operate Unit B as well as to sell a certain amount of power to X. In exchange, X became obligated to provide Fuel Source A (or alternative fuel) for Unit B and pay the Taxpayer for the power X would receive. Originally, X also paid monthly inducement fees of approximately C Amount while the Taxpayer built the Unit B.[2] Previous agreements as well as the current Agreement allow X to express its views regarding the operation of Unit B; however, the Agreement also makes clear that X's role is advisory only.

Firm Power Commitment

Under previous agreements and the current Agreement, the Taxpayer is obligated to sell X a certain amount of "firm" power (i.e., a fixed amount of power), but it is not required to deliver that power specifically from Unit B. X's power supply is not "unit specific." That is, the Taxpayer is completely obligated to provide power to X, whether or not Unit B is operating. However, when Unit B is not operating, X is obligated to pay the market price according to section g of the contract. When Unit B is operating, X pays the specifically calculated price as defined in sections f and g of the contract. In addition, X is also required to supply the fuel source and water.

Current Amended Amendment (Year 1)

In Year 1, X and Taxpayer amended the Agreement. The key terms of the Year 1 amendment extended Taxpayer's "firm" power obligation by almost y years to Year 5. Below are some of the relevant provisions contained in the Agreement.

Definitions - Section a.

The term the Station is used herein to mean the totality consisting of: (a) Unit A; (b) Unit B; (c) Station Real Estate; (d) Common Facilities; (e) Fuel Source A Facilities. Importantly, X owns (a) and (e), Taxpayer owns (b), X owns all of (c) except for the Unit B Real Estate, and X owns all of (d) except for the Unit B Common Facilities.

Ownership - Section b.

X conveyed land to Taxpayer for the construction of Unit B. Taxpayer

[2] Total inducement fees of approximately D Amount were paid during the w month period from Date 5 to Date 6. This is the period from the date the contract was signed up to the time the Unit B was up and operational.

paid X the average cost paid by X for the property, per Section 6.1 of the Power Contract. X has the right and option to buy back the generating unit, land, and all improvements if the Taxpayer decides to sell it. The purchase price would be current fair market value, but not less than the original cost of Unit B, all additions thereto, and all additions to Common Facilities, less retirements and depreciation at E Amount per year. This right would terminate upon the earlier of (i) the later of the termination of this Agreement or the occurrence of a Smelter Closing Event: or (ii) the expiration of twenty-one years after the death of the survivor of the children of certain persons named.

X also has the right and option to purchase the land from the Taxpayer upon expiration of the useful life of Unit B as mutually determined by the parties. X would pay the same cost as the Taxpayer paid for the properties.

Power and energy - Section c.

Taxpayer is entitled to the power and energy output of Unit B, except for the Firm Power amount [as defined in Section c] during the term of the agreement. (emphasis added). The Firm Power amount was initially F Amount. This amount was increased to G Amount in the 4th Amendment dated Date 7. During periods of scheduled and unscheduled outages of Unit B, Taxpayer will use its best efforts to supply power and energy to meet its obligations. However, if Taxpayer fails to supply the power to X, X has the right to further reduce the power and energy to be supplied in order to make efficient use of the power and energy which is supplied during such failure. Notably, the Taxpayer's obligation to provide power is suspended upon X's failure to provide Fuel Source A or other acceptable fuel.

X is prohibited from reselling, redelivering, assigning, or otherwise transferring any of the power and energy that it purchases from the Taxpayer under this Agreement to any entity other than the Taxpayer. X may not purchase, accept delivery from, take an assignment of, or otherwise receive, power and energy from anyone other than the Taxpayer for the existing X facilities at Location 1, unless it is consuming all of the power and energy to which it is entitled under the Agreement.

Supply of Water- Section d.

X shall be responsible for supplying water, from the Lake and from purchased water for the operation of Unit B. Delivery of such water to Taxpayer shall be at Lake. To the extent X is unable to provide sufficient water for the operation of Unit A and Unit B, the water available shall be supplied to Unit A and Unit B on a proportional basis with Unit B receiving H Amount of the available water.[3] The cost of such water is included in the Operating Costs.

[3] I Amount represents the output capacity of Unit B and J Amount represents the total output capacity of the Units A and B.

Fuel Source A - Section e.

X is required to furnish enough Fuel Source A (or an alternate fuel) to the Taxpayer at the Station to assure a continuous ability to generate power at K Amount of annual load factor equal to L Amount[4] of the capacity of Unit B over the term of the Agreement. Taxpayer paid X for this Fuel Source A based on a formula.

X must also furnish, at no cost to the Taxpayer, enough Fuel Source A to generate the power purchased by X and any surplus power. If Taxpayer fails to furnish the required power, X may suspend the furnishing of Fuel Source A required for the Firm Power commitment. Additionally, X may purchase M Amount of Unit B and Unit B Real Estate from Taxpayer at its current fair market value, which could not be less than M Amount of the cost of Unit B.

Operation of the Station - Section f.

Taxpayer shall continue to operate Station pursuant to the Operating Contract except for the modification made in Section f, subsection (1). X agrees to pay M Amount and Taxpayer pays L Amount of the monthly Unit B Operating costs. The Taxpayer pays a monthly Common Facilities Charge.

Per Subsection (2): At the end of each calendar year, X pays the Taxpayer a Supplemental Operating Fee, which is the amount, if any, by which the Minimum Fee Amount (N Amount) exceeds the sum of (i) the Operating Fees for the calendar year, (ii) the Additional Operating Fees for the calendar year; and one-third of the cost of capital payments that X paid to Taxpayer under this Agreement for the calendar year.

Price of power - Section g.

X pays the Taxpayer monthly (i) O Amount of the Taxpayer's cost of capital (P Amount in the original agreement, Q Amount at Date 9) on original cost of Unit B, less depreciation, and (ii) O Amount depreciation at E Amount per year on a straight-line basis.

The amount to be paid to Taxpayer by X shall be reduced on a proportionate basis to the extent that Taxpayer does not make available the Firm Power Amount to X. X does not pay for any of the Firm Power Amount that is not provided.

X pays the Z charges *(i.e.* the market price of electricity) that the Taxpayer incurs, directly or indirectly, when power is delivered from the market instead of from Unit B.

[4] This represents Taxpayer's portion of the Unit B Output.

Assignment - Section h

Neither party shall assign this Agreement nor any right or obligation hereunder without the prior written consent of the other. Such consent may not be unreasonably withheld or delayed.

Review of Agreement- Section i

At any time after Date 10, if the Taxpayer determines that the costs of producing energy from Unit B exceed the market price for at least the next two years, it will notify X. The parties will then negotiate if the Agreement can be satisfied to the mutual satisfaction of both parties.

Smelting Closing Event

The Agreement entitles X to declare a "Smelter Closing Event" as early as Date 8 and consequently shut down the Location 1 smelter without losing the right to take "firm" power. Under a Smelter Closing Event, X could sell the entire amount of firm power (less the small amount of power it designated for use after a smelter shutdown) and retain R Amount of the revenue.

A Smelter Closing Event is defined as occurring on the first day of the first calendar month after the later of (i) Date 8, (ii) ninety days after the Taxpayer receives written notice from X that it has, or will permanently cease smelting on the plant site; and (iii) the date that X does, in fact, permanently cease smelting on the plant site.

LAW AND ANALYSIS

Issue 1: Taxpayer may be a dealer in commodities.

Section 475(e)(1) provides that in the case of a taxpayer who elects to be treated as a dealer in commodities, this section applies to commodities held by the dealer in the same manner as the rules apply to a dealer in securities. Therefore, a dealer in commodities is a taxpayer who regularly purchases commodities from or sells commodities to customers in the ordinary course of a trade or business, or who is willing to enter into, offset, assign or otherwise terminate positions in commodities with customers in the ordinary course of business. See I.R.C. § 475(c)(1)(A) and (B). Once a taxpayer makes an election under section 475(e), it must mark all commodities under section 475(e) (2) which have not been specifically identified as held for investment or otherwise exempt from marking. A taxpayer can not just pick and chose which commodities it wants to mark, unless it falls within exception to marking mentioned in the preceding sentence. For example, if it is determined that Taxpayer is a dealer in commodities because of its activities with sales of electricity outside of the Agreement, then any other commodities must be marked, regardless of whether Taxpayer is a

dealer in that commodity, unless such commodity has been properly identified as exempt from marking.

In your incoming request, the position asserted is that Taxpayer is not a dealer in commodities. This position seems to be based only upon taxpayer's activities in regards to the Agreement, and possibly also two other similar agreements, Contract A and Contract B.[5] Although the incoming request also mentions that Taxpayer claims to be a dealer in commodities because of retail gas contracts, which it claims are hedges for book purposes, the request doesn't really address that aspect. In addition, the incoming request asserts that Taxpayer does not claim to be a dealer in commodities because of its sales in electricity outside of the Agreement or its contracts for Fuel Source A, so the request doesn't address the impact these activities have on Taxpayer's dealer status.

Although we do not think Taxpayer is a dealer in commodities because of its activities under the Agreement,[6] the fact that it has asserted that is a dealer in retail gas contracts, and that it may also sell electricity to other customers, beside X, may support Taxpayer being a dealer in commodities. At least, these activities should be looked at and considered before asserting whether or not Taxpayer is a dealer in commodities. We note also that the Form 3115 filed by Taxpayer regarding its election under section 475(e) states that it has several trades or businesses, including that of being a dealer in commodities (although it doesn't specifically assert natural gas), and that it also generates electricity for sale to related and unrelated parties, including retail customers throughout its service territory.

An election under section 475(e) applies on an entity by entity basis. An election must be made by or for a specific entity, regardless of whether that entity is a member of a consolidated group, the parent of which may have made an election. Section 475 will only apply to the specific entity making the election or in the case of a consolidated group, a parent specifically making an election for the different entities to which section 475 shall apply. In this case, Taxpayer made the election, and now we need to determine whether the activity involving the retail gas contracts and the sale of electricity to customers outside of the Agreement occurs within one tax entity, Taxpayer. As we noted, it appears from what Taxpayer represented on its Form 3115, that may be the case, but you need to confirm that is so.

Retail Gas Contracts

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[5] Contract A and Contract B are briefly mentioned in this incoming request as contracts similar to the Agreement at issue here, but involve generating wind capacity and coal. Taxpayer is marking these contracts under section 475. At this point in time not enough detail has been presented on these contracts for the National Office to render an opinion on them.

[6] We agree with your analysis and do not think the Agreement or portions of the Agreement is a commodity under section 475(e) (2). See discussion under Issue 2.

Natural gas is an actively traded commodity, so whether Taxpayer is purchasing or selling natural gas or a forward contract or some similar type contract in gas, it is either a commodity subject to marking either under section 475(e)(2)(A) or (C). If Taxpayer regularly purchases or sells gas contracts to customers in the ordinary course of its trade or business, it would qualify as a dealer. Since no facts were presented about the retail gas contracts, this is something that should be developed further. Key components in making the dealer determination are whether the purchases or sales occur regularly and with customers in the ordinary course of taxpayer's business.

Sales of Electricity

Similarly, electricity is most likely a commodity, and any regular sales of electricity to customers, other than X, may qualify taxpayer as a dealer in commodities. The Agreement does provide that Taxpayer may sell excess capacity of electricity in the retail market, once it has met it obligation to X. Taxpayer asserts in its Form 3115 that it does sell electricity to retail customers, as well as related parties. The sales to related parties can be with customers. It must also be determined if these sales occurred regularly and with customers.

Other Possible Commodities

We also mention that Fuel Source A may be a commodity and subject to marking under section 475. Likewise, water is probably a commodity. In both cases, Taxpayer is acquiring Fuel Source A and water from X as part of its payment for the electricity. Although there may be hazards to our argument that Fuel Source A is an actively traded commodity based upon the cost and ability to transport it, we think it is an argument that can and should be made.

We think before a determination can be made that Taxpayer is not a dealer in commodities, your office must look beyond Taxpayer's activities under the Agreement in making the dealer determination.

In the incoming request, the analysis as to whether the Taxpayer is a dealer seemed to focus primarily on the body of dealer/trader case law developed over the years, rather than the language of the section 475.[7] A reason asserted for not finding dealer status is the fact that the Taxpayer does not purchase and resell electricity or the Agreement (containing provisions regarding the operations of the electricity plant and sales of the electricity to X). The request asserts that the Taxpayer did not serve a middleman or merchandising function in either case. However, we want to point out that the statutory definition of a dealer in securities or commodities under section 475 is broader than the dealer requirements discussed in case law distinguishing between a dealer and a trader. That case law was addressing code sections other than section

[7] See Kemon v. Commissioner, 16 T.C. 1026 (1951); Bielfeldt v. Commissioner, T.C. Memo 1998-394, aff'd 231 F.3d 1035 (7th Cir. 2000).

475. Under the case law, dealers were required to both buy and sell securities/ commodities. Compare that to the statutory requirement under section 475, a dealer need only buy or sell. A dealer under section 475 can include a taxpayer who regularly only purchases securities or commodities from customers in the ordinary course of business, regardless of whether it sells those securities or commodities.

The case law distinguishing dealer from trader also focused on whether a taxpayer regularly purchased and sold to customers in the ordinary course of business. The discussion of whether a taxpayer is a dealer in the case law is very circular in that the purchase and resale requirement is also deeply tied to the determination as to whether the sale was to customers. The case law has developed a requirement that a dealer receives remuneration for their labors as a middleman, bringing together buyer and seller and acting as a retailer or wholesaler of goods. Bielfeldt, supra at 32; Kemon, supra at 1032-1033. When applying this case law under section 475, we need to make sure that we do not get caught up on the purchase and resale requirement that is not part of section 475. We think your analysis may have done so. However, we do need to use this case law to help in making the customer determination.

Issue 2- The Agreement is not a Commodity

Taxpayer is asserting that certain provisions of the Agreement, specifically sections c and g, when severed from the rest of the Agreement is a section 475(e)(2)(C) commodity - an evidence of an interest in or a derivative instrument in, any commodity described in subparagraph (A) or (B), including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity. Taxpayer asserts that the underlying commodity is electricity. The incoming request for advice asserts, first, that the Agreement is not severable, and as such the Agreement is not a commodity under section 475(e)(2). Second, even if the Agreement were severable, Sections c and g of the agreement are not a commodity under section 475(e)(2)(C).

We are in agreement with your conclusions and most of the analysis set forth in your incoming request on this issue. Therefore, we will not go through repeating such analysis in this response, but we will list our agreement or disagreement or any clarifications or modifications that should be considered.

We agree that the Agreement is not a commodity under section 475(e)(2)(C) and that it is a cost of services contract or as you call it, a tolling agreement. We agree with you analysis that the Agreement is not severable under law (though we claim no expertise in law) and that the year 4 Valuation Report claim of severability is unrealistic.

The request goes on to assert that even if the Agreement were severable, the selected provisions are not a commodity. We agree, however we do have some clarifications.

On page 18 of your analysis, you state that the legislative history indicates that a commodity for purposes of section 475(e) (2) (A) would include only commodities of the a kind customarily dealt in on an organized commodities exchange. Although that is legislative history from the House bill, it does not reflect what happened when the bill went to conference. The legislative history for that bill indicates that the conference agreement expanded the definition of a commodity for purposes of the provision to include any commodity that is actively traded (within the meaning of section 1092(d)(1)). See H.R. Conf. Rep. No. 105-220, at 516 (1997), reprinted in 1997-4 C.B. 1457, 1986. See also Joint Committee on Taxation, The General Explanation of the Tax Legislation Enacted in 1997 ("Blue Book") 181 (Comm. Print 1997), reprinted in 1997-3 C.B. 89, 291.

Under that expansive definition of actively traded, it is likely that electricity is covered by section 475(e)(2)(A). However, that does not mean that the selected provisions of the Agreement are a commodity under section 475(e)(2)(C). As asserted in your request, these selected provisions are part of a tolling agreement or a cost of services contract. If severed, these provisions would not be like a forward contract or futures contract because these provisions are not based on market rates, in fact these provisions are based upon cost of services, and the electricity rates are below market rates.

Issue 3-The Taxpayer's treatment of the Agreement does not clearly reflect income

We agree with the conclusions and the analysis set forth in your incoming request. We have no additional comments, except those noted below under Case Development.

Issue 4- Taxpayer holds an offsetting position to its obligations to provide and sell the firm power and energy to X under the Agreement

We agree with the conclusion and the analysis set forth in the incoming request. We have no additional comments, except those noted below under Hazards.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

As noted under the discussion for Issue 1, to determine whether Taxpayer is a dealer in commodities (for commodities other than the Agreement) may require further factual development. However, even if Taxpayer is a dealer in commodities based upon its activities related to the natural gas contracts or its sales of electricity outside of the Agreement, that does not impact your conclusion that Taxpayer can not mark certain provisions of the Agreement because it is not a commodity under section 475(e)(2). Whether there are hazards to arguing that Taxpayer regularly sells electricity to customers, we can not opine on that at this point because further factual

development is needed. Likewise for the natural gas contracts, depending upon the factual development, there may or may not be hazards as to arguing that Taxpayer has customers. We just don't know enough about these contracts. You should also clarify that these sales of electricity and the trading activity with the natural gas are all happening in the same entity. [redacted]

As to Issue 3, regarding the clear reflection of income argument, we think it is also worth noting that although Taxpayer is claiming a huge mark-to-market loss on two provisions of this Agreement, the Taxpayer amended the Agreement to be in force for an additional y years. If this mark-to-market loss from two provisions were a true reflection of the economics of this Agreement, Taxpayer would not have extended the Agreement for the additional years.

As to Issue 4, the offsetting position argument under section 1092, although we think that argument should be made, [redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-7794 if you have any further questions.

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