INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

July 12, 2011

Number: **201142020**
Release Date: 10/21/2011

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 446.33-00, 1001.00-00, 1221.12-02, 1234.00-00
CASE-MIS No.: TAM-106672-11

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Year 1 =

Pre-Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 6 =

Year 7 =

Year 8 =

Year 9	=
Year 10	=
Year 11	=
Year 13	=
Commodity X	=
Counterparty A	=
Counterparty B	=
Counterparty C	=
Percentage	=
Location	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=

m	=	
n	=	
Amount 1	=	$
Amount 2	=	$
Amount 3	=	$
Amount 4	=	$
Amount 5	=	$
Amount 6	=	$
Amount 7	=	$
Amount 8	=	$
Amount 9	=	$
Amount 10	=	$
Amount 11	=	$
Amount 12	=	$
Amount 13	=	$
Amount 14	=	$
Month A/Year 1	=	
Month A	=	
Measurement Standard	=	
Public Document 1	=	
Quote 1	=	

Year 1 Document =

Quote 2 =

Public Document 2 =

Indirect Quote 3 =

Accounting Firm =

Commodity Type =

Label X =

Document 3 =

Indirect Quote 4 =

Indirect Quote 5 =

Ingredient =

Indirect Quote 6 =

ISSUES:

(1) Whether Taxpayer's Year 1 written call options on Commodity X continued to be options after they were restructured in Year 3, such that the losses from the closing of those transactions were capital losses covered by section 1234(b)?

(2) Whether the changes to Taxpayer's written call options on Commodity X caused those contracts to be materially modified under section 1001, resulting in an exchange of the options at the time of their restructuring?

(3) Whether Taxpayer's written calls, as restructured, were hedging transactions under the section 1.1221-2 hedging regulations?

(4) Whether Taxpayer was permitted to take losses on the Year 1 written call options, as restructured, at the time of their closing in Year 9 and, if not, whether Exam's chosen method of accounting for the losses is improperly unlawful or arbitrary?

CONCLUSIONS:

(1) Taxpayer's Year 1 written call options on Commodity X continued to be options after they were restructured in Year 3, such that the losses from the closing of those transactions were capital losses covered by section 1234(b).

(2) Taxpayer's changes to the restructured contracts with Counterparty A and Counterparty B were not material and did not result in an exchange under section 1001 at the time of their restructuring. Taxpayer's changes to the restructured contracts assigned to Counterparty C were material and resulted in an exchange under section 1001.

(3) Taxpayer's written calls, as restructured, were hedging transactions under the section 1.1221-2 hedging regulations.

(4) Taxpayer was not permitted to take losses on the Year 1 written call options, as restructured, at the time of their closing in Year 9, and Exam's chosen method of accounting for the losses is not improperly unlawful or arbitrary.

FACTS:

Taxpayer is a worldwide Commodity X producer. In Year 1, more than Percentage of Taxpayer's Commodity X production revenue was derived from its Location operations. Taxpayer is a calendar year taxpayer that uses the FIFO method of accounting, valuing its inventory at the lower of cost or market.

Converting Commodity X reserves into a product that can be sold or traded is an extensive process that generally takes less than a year. Taxpayer generally enters into agreements to sell fully refined Commodity X immediately prior to completion of the entire refining process or immediately thereafter. Fully refined Commodity X held as inventory represents less than a% of Taxpayer's total annual sales.

Taxpayer's performance is highly sensitive to fluctuations in the market price of Commodity X. In Pre-Year 1, the average price of Commodity X began to fall and continued to fall through Year 1. By mid-Year 1, the price of Commodity X reached a b year low of Amount 1. In Year 1 through Year 3, the average price of Commodity X was just under Amount 2. Beginning in Year 4, the average price of Commodity X began to significantly increase.

Taxpayer has historically not hedged its commodity production, but it has strategically deviated from that policy from time to time. Taxpayer occasionally entered into commodity contracts to protect the selling price for limited amounts of anticipated Commodity X production. However, Taxpayer does not hold such instruments for trading or speculative purposes.

With the price of Commodity X dropping in Year 1, Taxpayer considered entering into Commodity X commodity contracts to protect its downside exposure to Commodity X prices and its breakeven point. Early in Month A/Year 1, Taxpayer's Executive-Finance Committee authorized entering into a prepaid forward contract on Commodity X; it used the substantial proceeds from the prepaid forward sale to reduce long-term debt.

Also, in late Month A/Year 1, Taxpayer personnel gave a presentation entitled "Strategic Revenue Management" to the Executive-Finance Committee in which Commodity X hedging strategies for both low and high price environments were described. The use of purchased puts, written calls and forwards as revenue management tools was referenced in the presentation, but the focus was on obtaining breakeven price protection in the near term (out to c years) through the purchase of short-dated Commodity X put contracts. In the presentation, the board committee was furnished a d year histogram showing that, even in a more favorable pricing environment, Commodity X had traded e% of the time over the past d years in an approximate Amount 3 range – between roughly Amount 4 and Amount 5. The presentation discussed undertaking "hedge positions" (particularly referencing the use of forwards and the sale of written call options) in rising price environments. The presentation described a "hedge horizon" of d years and set forth the maximum hedge positions by Measurement Standard and committed sales price. The commitment percentages to written calls and forward sales over varying price ranges were delineated, with a maximum of f% commitment (as a percentage of the maximum committed production over the hedge horizon) for the upper Amount 6 to Amount 7 price range. Consistent with Taxpayer's publicly stated policy, speculative trading was not recommended.

In late MonthA/Year 1, Taxpayer's board approved the purchase of put options that would cover specified levels of Commodity X production over the next c years, "financed" by the sale of long-dated call options. In its Public Document 1, Taxpayer stated that it entered into Quote 1. At that time, Taxpayer had in place a Amount 8 revolving credit facility with a consortium of banks, of which Amount 9 was outstanding under the facility.[1]

Year 1 Purchased Puts

To protect against further price declines, Taxpayer purchased European-style put options with respect to g of Commodity X from Counterparty A and Counterparty B for Amount 10. Shortly thereafter, the price of Commodity X rebounded. The puts expired worthless in Year 1 and Year 2. Taxpayer reported ordinary loss equal to the allocable premium for contracts expiring in each year. Taxpayer had not identified the puts as hedging transactions for tax purposes, but later asserted in writing that the purchased puts were qualifying hedging transactions under section 1221.

Year 1 Sold Calls

Taxpayer also decided to sell calls, which relinquished some of its upside opportunity associated with anticipated future sales of h of Commodity X. The premium received from the same counterparties of Amount 10 paid for the cost of the purchased puts. The European-style calls had various expiration dates in Year 6, Year 7, Year 10, and Year 11. The strike prices were well out-of-the-money. The Counterparty B written calls provided for physical settlement, whereas the Counterparty A written calls provided for cash settlement. Because the cost of the purchased puts equaled the amount due for the written calls, no cash was exchanged between Taxpayer and the counterparties. Taxpayer also did not identify the written calls as hedges or identify the hedged items for tax purposes. The sold calls were not treated as hedges for financial accounting purposes and were marked to market periodically through Taxpayer's income statement.

With Commodity X prices increasing, Taxpayer issued an Year 1 Document discussing its hedging position. Taxpayer described its exposure on the written calls as the Quote 2. Consistent therewith, in discussing hedging risk, Taxpayer stated that Public

---

[1] It is unknown whether Taxpayer considered issuing debt to "finance" the cost of the purchased puts or using existing cash, including the cash generated from the contemporaneous sale of the prepaid forward that was used to pay down long term debt. Exam had requested information showing that Taxpayer had assessed alternative means of paying for the purchased puts, but Taxpayer advised no responsive information could be provided or located.

Document 2. Taxpayer still considered an increase in the price of Commodity X to be a good scenario for the company as most of its reserves would be sold at the higher prices. Taxpayer explained in the Year 1 Document that it Indirect Quote 3.

In mid-Year 3 "Hedging Update" reports prepared for Taxpayer's board of directors, Taxpayer set forth the current hedge book status of several of its hedges by anticipated production year. The reports showed the distribution by Measurement Standard of Commodity X by production years for prepaid forwards, forward sales, put/call collars and the written calls at issue here.[2] The hedging book covered only a modest portion of Taxpayer's Commodity X reserves and future sales.

Year 3 Restructured Contracts

After the purchased puts expired worthless, Taxpayer in Year 3 restructured the written call options so that it could take the position on its financials that the transactions were "normal sales" under FAS 138, thereby avoiding the application of FAS 133 and the recognition of unrealized losses under that standard's mark-to-market rules. Documentation in one of the restructured contracts indicated that the "restructured positions" were to comply with specifications set forth in Accounting Firm's opinion letter to qualify for FAS 138 compliant normal sales accounting treatment."[3]

For the most part, the restructured contracts mirrored the original written calls in that they capped Taxpayer's revenue from future production, generally for the same Measurement Standard of Commodity X and at the same price and time as the written calls. However, certain terms in the original written calls were changed. Generally, the restructured contracts "required" physical settlement, as did the original Year 1 Counterparty B calls.[4] Counterparty C replaced Counterparty A as the counterparty on some of the written calls and the exercise dates were extended by c years for those

[2] Taxpayer's treatment of other hedging transactions, including those unrelated to the sale of future Commodity X production, was not known or considered in preparing this technical advice.

[3] Although the financial accounting opinion and other relevant emails and documents describing the restructuring changes were requested, Taxpayer advised that no documentation pertaining to its accounting position or documents discussing the changes could be provided or located.

[4] Extensive information was sought by Exam from Taxpayer on the "required" delivery, including an explanation of whether and why Taxpayer believed delivery was required and its views on the implications of failing to make or take delivery. Exam also asked whether the counterparties took title to Commodity X that was "delivered" in Year 7 under some of the restructured positions. Taxpayer only stated that it is continuing to search for responsive information and will provide it if it is located.

contracts. Most notably, the restructured contracts added a spot price delivery feature to the prior contracts. The spot price delivery feature called for physical delivery to be made by Taxpayer to the counterparties at the lesser of the written call strike price (as adjusted for some of the contracts) or the fair market value of Commodity X at the time of scheduled delivery. In addition, the counterparties did not have to formally exercise the options to obtain the intrinsic value in the restructured contracts as delivery automatically would be made at the lower strike price if the contract was in-the-money. Generally, the trade confirmations continued to refer to the restructured contracts as options.

Further distinctions among the restructured contracts, by counterparty, are summarized below.

Restructured Counterparty A Written Calls

Counterparty A provided Taxpayer with documentation entitled "Physically Settled Commodity Type Forward Transaction Confirmation." However, the confirmations described these trades as "Your Sale of OTC Options" and further described the transactions as European call options with strike prices that were Amount 11 less than the original Year 1 written call strike prices.

Restructured Counterparty B Written Calls

Counterparty B provided Taxpayer documentation entitled "Amendment Re: Commodity Type Transaction – Physically Settled." The trade date listed is the original Year 1 written option trade date. Instead of a being exercisable at the end of Month A Year 10 and Month A Year 11, the restructured agreement provided that deliveries of the same overall Measurement Standard of Commodity X would be made on a prorated basis over each month in Year 10 and Year 11 that straddled the single prior Month A Year 10 and Month A Year 11 exercise dates. The capped prices for the restructured contracts were Amount 12 less than the strike prices of the Year 1 written call options.

Restructured Written Calls Assigned to Counterparty C

Pursuant to a novation and assignment agreement, Counterparty C was substituted for Counterparty A as the counterparty on several written calls. Counterparty C provided Taxpayer a confirmation entitled "Commodity Type Bullion Option Confirmation." The confirmation trade date was current and described the transaction as a new European call. As contrasted with the novation agreement, which stated that the terms of the Year 1 written call continued to apply, the expiration dates in the confirmations were extended by more than c years.

Generally, Taxpayer publicly referred to these restructured contracts as Label X. In its Document 3, Taxpayer described the restructured contracts as Indirect Quote 4.

Nothing in the terms of the restructured contracts precluded, as was ultimately done, closing out the transactions without delivery, and no information was provided on the implications of the parties not making or taking physical delivery.[5]

Taxpayer did not treat the restructuring of the contracts as triggering an exchange or deemed exchange under section 1001 on its originally filed Year 3 returns. In early Year 9, while the IRS Appeals Office was considering audit adjustments proposed to Taxpayer's Year 3 return, Appeals notified the audit team that Taxpayer had claimed a section 1001 loss with respect to the restructuring of the written calls. The Service rejected that claim, and Taxpayer did not further press the matter. Taxpayer also did not identify the restructured contracts as hedges for Federal income tax purposes.

Year 9 Closing Transactions

By early Year 8, the price of Commodity X had increased dramatically. At that time, in a presentation entitled "Financial Exposure Update," Taxpayer described in detail the exposure associated with its "Legacy Commodity X Hedging" and set forth solutions for addressing such. The largest hedge exposure discussed was the restructured contracts. That presentation described the opportunity or revenue loss by year associated with future Commodity X production in the Year 10, Year 11 and Year 13 years covered by the restructured contracts. A chart was included that highlighted the cost of buying back the restructured contracts based on the "call strike, intrinsic value and time value." The presentation stated that the chart (showing the time and intrinsic value for each contract) "illustrates the 'expensive' nature of buying back the upside on the longer-dated option positions." The proposed buy back of the restructured contracts was described as being consistent with the desire to be unhedged. In a later update, the hedge buy back alternative was described as having an "Adverse Accounting and Tax Impact," but the status quo was described as inconsistent with being a "non-hedger." Also in the presentation, Taxpayer described a strategy of buying a "call option [that] would exactly match and offset the existing [restructured contract] (sold call options)." The presentation suggested the possibility of replacing the restructured contracts with a d year forward with a fixed (off-market) strike price.

In mid-Year 9, Taxpayer personnel recommended to the Taxpayer board that it unwind its Commodity X hedge positions and close out its hedge book, including the restructured contracts for the i of Commodity X. Immediately thereafter, Taxpayer entered into a series of agreements to terminate its remaining delivery obligations under the restructured contracts. The Counterparty A and Counterparty C confirmations described the transactions as option terminations. Taxpayer paid the counterparties

---

[5] For purposes of this technical advice only, it is assumed that physical deliveries were made to Counterparty C in Year 7 and were legally required except where the transactions were otherwise closed out.

Amount 13 to close out the contracts and claimed an ordinary loss of Amount 14 for tax purposes.[6]

LAW AND ANALYSIS:

Issue 1: Whether Taxpayer's Year 1 written call options on Commodity X continued to be options after they were restructured in Year 3, such that the losses from the closing of those transactions were capital losses covered by section 1234(b)?

Section 1.1221-2 provides ordinary treatment for hedging transactions if they are timely identified or where the failure to timely identify is excused under the inadvertent error exception. None of the written calls or restructured contracts was timely identified as hedging transactions for purposes of section 1.1221-2. Further, no facts were provided to support any contention that the failure to identify the written calls or restructured contract was attributable to inadvertent error.[7]

Section 1234(b) provides a character rule for closing transactions involving options on certain property, including commodities such as Commodity X. Section 1234(b)(1) provides that in the case of the grantor of the option, gain or loss from any closing transaction with respect to, and gain on lapse of, an option in property shall be treated as a gain or loss from the sale or exchange of a capital asset held for not more than 1 year. Section 1234(b)(2)(A) provides that the term "closing transaction" means any termination of the taxpayer's obligation under an option in property other than through the exercise or lapse of the option.

[6] The claimed loss was largely based on the difference between the allocable premium received on the Year 1 written call options and the cash cost of closing out the restructured contracts. This technical advice does not address the ancillary aspects of Taxpayer's realized loss calculation that were discussed in the presubmission conference.

[7] No opinion is expressed on the possible application of the inadvertent error exception to the type of circumstances herein or on Taxpayer's particular claim that is being raised years after it knew of its failure to identify. Section 1.1221-2(g)(2)(ii)(C) also requires that a taxpayer claiming inadvertent error must treat all qualifying hedging transactions in all open years as hedges. Because all facts and circumstances would be relevant to determining whether Taxpayer's failure to identify was inadvertent error, Taxpayer's identification and treatment of the Year 1 purchased puts and all of its other hedging transactions, whether involving commodities or otherwise, should be considered.

Taxpayer contends that section 1234(b) is not applicable because the restructured contracts were not options in substance, but instead were forward contracts. Taxpayer also argues that, as a result of the restructuring, the calls were exchanged for bilateral contracts because the addition of a spot price delivery feature eliminated the counterparties' "optionality" or truly alternative choice -- as required for option treatment. In short, Taxpayer asserts that section 1234 no longer applied to the written calls after their restructuring.

An option contract provides a holder with the right or privilege, in return for a premium, to buy or sell specified property at a specified price on or before a specified time period. W.A. Drake, Inc. v. Commissioner, 3 T.C. 33, 37 (1944); Rev. Rul. 58-234, 1958-1 C.B. 279; Rev. Rul. 78-182, 1978-1 C.B. 265. There is no dispute that the Year 1 written calls were options for purposes of section 1234. Even after their restructuring, however, the contracts continued to have the key option elements, i.e., the counterparties had the right to acquire specified property (Commodity X) at specified dates and for a specified price. The premium paid by the counterparties in Year 1 was not reduced or refunded in any way. Thus, in form at least, the restructured contracts continued to have the essential elements of an option on property.

However, Taxpayer argues that the addition of the spot price delivery feature caused the restructured contracts to no longer be options in substance because the counterparties lacked "optionality" or the truly alternative choice of whether to take delivery. A call option obligates the writer to sell property at a fixed price; a holder has optionality or choice in being permitted, but not required, to acquire the property at that price. Rev. Rul 58-234.[8] Consequently, the holder of a call option is not exposed to a decrease in the value of the option property except to the extent of premium that has been paid. Estate of Franklin v. Commissioner, 64 T.C. 752, 762 (1975) (citing U.S. Freight Co. v. United States, 422 F.2d 887 (Ct. Cl. 1970)). See also, Halle v. United States, 83 F.3d 649, 657 (4th Cir. 1996) (option contracts permit parties to shift pricing risk such that a call option holder acquires the benefit of price increases but the option seller bears the cost of any future price declines).

---

[8] In Rul. Rul. 58-234, the Service stated:

> An optionor, by the mere granting of an option to sell ("put"), or buy ("call"), certain property, may not have parted with any physical or tangible assets; but, just as the optionee thereby acquires a right to sell, or buy, certain property at a fixed price during a specified future period or on or before a specified future date, so does the optionor become obligated to accept, or deliver, such property at that price, if the option is exercised. (emphasis added)

Bilateral contracts like forwards do not shift pricing risk in the same asymmetric fashion as options. In a forward or other bilateral sales contract, the forward seller substantially or completely transfers the pricing risk with respect to the underlying property. Thus, a forward seller substantially locks in the price at which it commits to sell property in the future, thereby eliminating its exposure to future price movements.[9] By committing to purchase property at a fixed price, the forward buyer assumes the risk of increases or decreases of the underlying property value. The Tax Court further reinforced the critical distinction between options and bilateral contracts in Koch v. Commissioner, 67 T.C. 71 (1976). The court observed:

> As we have pointed out in a number of cases, the clear distinction between an option and a contract of sale is that an option gives a person a right to purchase at a fixed price within a limited period of time but imposes no obligation on the person to do so, whereas a contract of sale contains mutual and reciprocal obligations, the seller being obligated to sell and the purchaser being obligated to buy.

Id. at 82 (citing Drake, 3 T.C. 33 at 37).

The spot price delivery feature added to Taxpayer's restructured contracts had little or no economic impact. The added feature did not upset or alter the apportionment of pricing risks that was established by the Year 1 written call options. Except for some deminimis downward adjustment of the strike prices for some of the contracts, the restructured contracts continued to allow the counterparties to obtain the economic advantage of price increases beyond the specified fixed strike prices in the Year 1 written options without bearing any additional pricing risk (other than premium paid) for declines in Commodity X prices.

[9] Although Taxpayer characterized the restructured contracts as forwards, it acknowledged, citing Anschutz v. Commissioner, 135 T.C. 78 (2010), that forwards are executory contracts in which property is sold for a "generally fixed price." C.f., section 1259(d)(1) (forward contract means a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price; Seykota v. Commissioner, 61 T.C..M. (CCH) 2706 (1991) (a contract to deliver a commodity at a fixed date at a fixed price). The restructured contracts all required delivery at a specified price that was the lesser of a fixed price (generally the strike prices of the Year 1 written calls) or the spot price at the time of required delivery. Given the considerable uncertainty in Year 3 as to whether delivery under the restructured contracts would be made at the fixed price or the floating spot price, the contracts were not forward contracts requiring delivery of Commodity X at a fixed price. Further, ample evidence shows that Taxpayer continued to economically view the restructured contracts as written options, not as forwards.

The addition of the spot price delivery feature allows Taxpayer to argue that the restructured contracts were nominally bilateral in terms of assuring, absent a closing transaction, that there would still be some delivery if the price of Commodity X did not exceed the strike price. The fact that delivery was "required" should not preclude option treatment. The key distinction is not whether performance is legally required (as delivery is being assumed herein to have been if the contracts were not closed out in advance of expiration); it is whether the option holder was obligated to perform at that fixed price or suffer exposure or damages comparable to that which would be borne if it had committed to buying or selling at a fixed price. Unlike with forwards or other bilateral property contracts, an option holder is not exposed to damages measured by the difference between the underlying option property's value and the fixed option price. Halle, 83 F.3d 649 at 655-56. In short, an option holder purchases the right to favorable price movements only, giving it the ability to walk away from the agreement without further market based exposure. As pointed out in the often quoted Court of Claims decision in U.S. Freight, 422 F.2d 887 at 894, an option holder is only obligated to the extent of premium paid whereas the purchaser in a bilateral contract is liable for full contractual damages should he default. See also Franklin, 64 T.C. 752 at 763; Koch, 67 T.C. at 82-83. The greater the damage exposure and the closer the amount of damages to the loss that would be incurred on default of a bilateral contract for a fixed price, the less the contract looks like an option. Halle, 83 F.3d 649 at 655. In Halle, the court found that the contract at issue was not an option because the taxpayer did not have a choice of whether to purchase the stock at issue. The court hinged its reasoning on the fact that the specified liquidated damages amply covered the actual damages that the taxpayer would have owed had it failed to consummate the transaction at the agreed purchase price.

In this case, the counterparties were not obligated to take delivery under the restructured contracts at a fixed price. The only "obligation" was to take delivery at a spot price if the spot price was less than the fixed strike price. That obligation would certainly have not exposed the counterparties to any market-based pricing risk, as would be the case if the contract were a bilateral contract like a forward requiring performance based on a fixed price. It is unknown what, if any, damages might apply if the counterparties did not accept delivery at the spot price,[10] but the "cost" of having to acquire fungible property that can be readily resold at the same price is hardly the kind of exposure that would negate the optionality that the counterparties originally paid for.

[10] While it not clear what that exposure might have been, it is clear that any exposure would not have been market-based, measured by the decline in the price of Commodity X. Moreover, as a practical matter, any exposure would have been realistically limited to either taking or redirecting to another party the delivery of Commodity X as it is highly doubtful that a counterparty would have willfully breached an obligation that had significant financial accounting implications to a customer and posed little or no cost for it.

Further, the facts demonstrate that the counterparties and Taxpayer understood that the counterparties still had the same optionality as under the Year 1 written calls. The counterparties continued to characterize the contracts as options in confirmations and Taxpayer continued to internally view the restructured contracts as written calls which could be closed out by a payment to the counterparties to compensate for the intrinsic and time value of the calls.

Although not given significant attention in its opinion, at least one court has considered and concluded that the existence of a spot delivery price feature is not substantively meaningful in determining whether a contract is an option. In Federal Home Loan Mortgage Corp.v. Commissioner, 125 T.C. 248 (2005), the Tax Court considered whether the taxpayer had written put options when it regularly entered into contracts to purchase mortgages at a price that was the lesser of a spot price or a fixed price. In concluding that the contracts were options, the court found that the contracts required delivery at a specified price and the optionee paid a premium for the right to sell property for greater than its value on exercise.

Based on the facts presented, the restructured contracts continued to be options and their closing gave rise to capital losses under section 1234(b).[11]

Issue 2: Whether the changes to Taxpayer's written call options on Commodity X caused those contracts to be materially modified under section 1001, resulting in an exchange of the options at the time of their restructuring?

Taxpayer claims that the restructuring of the written calls in Year 3 gave rise to section 1001 exchanges. Taxpayer generally asserts that the restructured contracts, whether viewed as modified or exchanged, were materially different than the Year 1 written calls, thereby triggering loss in Year 3.

Section 1001 provides rules for the computation of gain or loss from the sale or other disposition of property. Section 1.1001-1(a) provides, as relevant here, that gain or loss is realized upon an exchange of property for other property differing materially in kind or in extent. See Cottage Savings Association v. Commissioner, 499 U.S. 554, 566 (1991) ("Under [the Court's] interpretation of [section] 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are 'materially different'-- that is, so long as they embody legally distinct entitlements"). Section 1.1001-3 provides specific guidance addressing when the exchange or amendment of a debt instrument will be considered a significant modification that results in an exchange of the original debt instrument for a modified instrument that differs materially in kind or in

[11] The fact that the amount of Taxpayer's loss here was wholly unaffected by the spot price delivery feature makes all the more compelling the conclusion that loss under the restructured contracts was appropriately determined under section 1234(b).

extent. Except for the limited guidance set forth in section 1.1001-4 regarding certain types of transfers or assignments, there is generally limited formal guidance addressing the exchange or modification of non-debt instruments. In Rev. Rul. 90-109, 1990-2 C.B. 191, the Service held that the exercise of an option in an insurance policy to change the insured constitutes a section 1001 sale or disposition where the substance of the original contract was fundamentally or materially changed. See also T.D. 8675 (section 1.1001-3 debt modification regulation preamble stating that the final regulations do not limit or otherwise affect the application of the "fundamental change" concept articulated in Rev. Rul. 90-109).

Taxpayer's overriding contention is that the restructuring of the Year 1 written options caused the instruments to become materially different financial instruments (forwards), causing a section 1001 exchange. However, as described above, Taxpayer's modifications did not change the nature of the Year 1 written call contracts. Except for the addition of the legally and economically inconsequential right to deliver at the applicable spot delivery price, the restructured contracts continued to function like classic options.

However, Taxpayer points to other changes (beyond the addition of the spot delivery feature) in the Year 3 restructuring that it asserts support section 1001 exchange treatment. The collective changes for each of the three counterparty arrangements are considered here.

Restructured Counterparty A Contracts

Apart from adding the spot physical delivery feature, the Counterparty A written calls changed very little. The strike price was reduced by Amount 11 and a physical delivery requirement was added.

The nominal reduction in the strike price was not a material modification. The strike price is certainly a fundamentally important aspect of an option contract. However, here the strike price was reduced by less than a% and was substantially greater than the market price at the time of modification. Further, the addition of a physical delivery requirement was not a material change. For fungible property that is readily traded, the obligation to take delivery does not generally constitute a meaningful right or obligation. That seems all the more true for parties, such as those involved here, that regularly make or take delivery of such products or can easily assign such obligations. Further, the fact that the contract could be closed out without physical delivery, as happened here, makes the physical delivery requirement an even less significant change. Finally, the fact that the right to physically deliver permitted Taxpayer to take the position that the restructured contracts did not have to be financially accounted for on a mark-to-market basis is not a change that goes to the legal and economic rights provided by the contracts.

Based on the totality of the changes, the Counterparty A restructured contracts did not materially differ in kind or extent from the Year 1 written options, so they were not deemed exchanged under section 1001.

Restructured Counterparty B Contracts

Apart from adding the spot physical delivery feature, the restructured contracts were amended to nominally reduce by Amount 12 the strike price of Commodity X and altered the exercise dates so that the Commodity X would be acquired over j months (in the same calendar year) that straddled each of the single mid-Year 10 and mid-Year 11 prior exercise dates.

The nominal reduction in the strike price was not a material modification. The strike price is certainly a fundamentally important aspect of an option contract. However, here the strike price was reduced by less than a% and the strike price was substantially greater than the market price at the time of modification of the long dated written calls. Because the Year 1 written options already called for physical delivery, the "requirement" of physical delivery was either not a change at all or of very little significance given the fungibility and liquidity of the underlying property.

The alteration of the delivery or expiration dates is a different matter, however, and of potentially greater significance. Generally, taxpayers that have extended the exercise dates of an option have been treated as entering into a new option rather than continuing the existing option. The time period over which the holder may choose to acquire or sell property goes to the essence of an option. <u>Reily v. Commissioner</u>, 53 T.C. 8, 12 (1969); <u>Succession of Brown v. Commissioner</u>, 56 T.C.M. (CCH) 1568 (1989). The term or exercise period of an option is of critical legal and economic importance because it goes to the essence of an option holder's ability to benefit from favorable changes in the price of the underlying property. In <u>Reily</u>, the Tax Court stated,

> An option is a contract which gives the optionee a right to buy, sell, lease or the like within a certain period of time. This time factor or limitation in an option is of the essence. It goes to the very nature of an option.

<u>Reily</u>, 53 T.C. 8 at 12.

Although section 1001 was not at issue in either <u>Reily</u> or <u>Brown</u>, both courts concluded that the options in those cases could not be treated as remaining open or continuing when the parties agreed to extend their expiration at or near the time of their originally scheduled expiration.

The extension of an option's life by several months or more (as with some of the options held by Counterparty B) would typically be significant as the exercise period goes to the essence of what is an option. In this case, however, several factors mitigate the impact of the Counterparty B expiration date changes. Although out-of-the-money, the Year 1 options were nowhere near expiring – having approximately l years of remaining life. Further, because the exercise dates were modified to straddle the prior exercise date, the mean exercise date of the new monthly delivery dates under the Year 3 restructured contracts only differed nominally from the prior relevant exercise date. Moreover, none of the new delivery dates were outside the taxable year of the original single mid-Year 10 and mid-Year 11 exercise dates.

Based on the totality of the changes, the Counterparty B restructured contracts did not materially differ in kind or extent from the Year 1 written options, so they were not deemed exchanged under section 1001.

Restructured Contracts Assigned to Counterparty C

Apart from adding the spot physical delivery feature, the Year 1 written calls assigned to Counterparty C were altered so that the original exercise dates were extended by more than c years. As indicated above, the exercise date of an option is a critically important feature going to the essence of an option. Although the call options were still materially out-of-the money in Year 3 and still had over l years of remaining life, the extension of the exercise period by over m% of the remaining term and beyond the taxable year end of the original options is a material change in and of itself.

The extension of the exercise date in the Counterparty C restructured contracts caused those contracts to materially differ in kind or extent from the Year 1 written calls; consequently, the Year 1 written calls assigned to Counterparty C were exchanged under section 1001 for the Counterparty C contracts.

Issue 3: Whether Taxpayer's written calls, as restructured, were hedging transactions under the section 1.1221-2 hedging regulations?

For purposes of the transactions and taxable years at issue here, the applicable section 1.1221-2(b) regulations generally defined a hedging transaction as a transaction that a taxpayer enters into in the normal course of its trade or business primarily to reduce risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer.[12] In the preamble to T.D. 8555 and the section 1.1221-2

[12] Because the transactions at issue were entered prior to the enactment of section 1221(a)(7) and the March 20, 2002 effective date of subsequently issued regulations, the section 1221 hedging regulations issued in 1994 pursuant to T.D. 8555, 1994-2 C.B. 180 (the "1994 regulations") generally govern. In late 1999, Congress enacted section 1221(a)(7) to modernize the hedging rules. Section 1221(a)(7) adopted a "risk management" standard as the lynchpin for hedging transaction treatment; however, the revised hedging regulations issued in 2002 continued to rely on the risk reduction

regulations, Treasury and the Service stated that, "[a]lthough the risk reduction standard has been retained, the final regulations provide rules of application designed to ensure that the definition of hedging transaction is applied reasonably to include most common types of hedging transactions."

Section 1.1221-2(c) of the 1994 regulations[13] set forth specific rules to guide in the application of the general definition of a hedging transaction for purposes of section (b). As most relevant here, section 1.1221-2(c)(1) provided that the determination of whether a transaction reduces risk is based on all of the facts and circumstances surrounding the taxpayer's business as well as the transaction itself. Paragraph (c)(1) further stated that a taxpayer's hedging strategies and policies, as reflected in the taxpayer's minutes or other records, are evidence of whether particular transactions reduce the taxpayer's risk. In addition, as specifically relevant to the instant case, section 1.1221-2(c)(1)(iii) addressed written options:

> A written option may reduce risk. For example, in appropriate circumstances, a written call option with respect to assets held by a taxpayer or a written put option with respect to assets to be acquired by a taxpayer may be a hedging transaction."[14]

Taxpayer generally argues that the written calls, as restructured, were not hedging transactions because they: (1) were "primarily" entered into to "finance" the purchased puts or obtain favorable accounting treatment; (2) did not substantially reduce pricing risk or risk of loss; and (3) did not hedge Commodity X it presently held.

---

standard and did not materially revise, at least as relevant here, the scope of the hedging regulations. Thus, the analysis of whether written calls are section 1.1221-2(b) hedging transactions should be the same under both the relevant old or new regulations.

[13] Unless specified otherwise, all references to the section 1221 hedging regulations are to the 1994 regulations.

[14] Written options were not addressed in the 1993 temporary and proposed regulations. Commentators complained that the regulations should cover written options and utilize a broader risk management standard. In adding section 1221(a)(7) to the Internal Revenue Code in late 1999 and adopting the "risk management" standard for hedging transaction treatment, the Senate Finance Committee observed that then-existing regulations had flexibly interpreted the risk reduction standard. The legislative history noted that the regulations had appropriately provided hedging transaction treatment to certain written call options, interest rate conversion transactions, dynamic hedges, partial hedges, recycled hedges and aggregate hedges. S. Rep. No. 106-201, at 24 n.12 (1999).

Argument #1: Not "Primarily" To Reduce Risk

Taxpayer contends that the written calls were not entered into "primarily to reduce risk" within the meaning of section 1.1221-2(b), but rather were entered into for the "primary purpose" of funding the premium paid for the purchased puts. Taxpayer argues that because the cash from the written calls was used to pay for the purchased puts, its primary purpose[15] for entering into the written calls was to finance a hedging transaction, not to reduce risk. In effect, Taxpayer argues that the use of the cash to pay for another hedging transaction (the purchased puts) precludes the written calls from being hedging transactions, even if the written calls or purchased puts reduced risk. Taxpayer further asserts that the financing motivation is evident because it would have been "irrational" for it to enter the written calls as independent hedging transactions. Taxpayer claims that Commodity X prices were volatile at that time, making it irrational to forsake substantial potential appreciation above the substantially out-of-the-money strike prices. Similarly, Taxpayer argues that the section 1001 modified contracts were not hedging transactions because the primary purpose for restructuring the agreements was to obtain more favorable financial accounting treatment.

Financing Assertion

Irrespective of how the "primarily" requirement is read, nothing in the section 1.1221-2 regulations supports the view that Taxpayer's use of the written call premium to fund the

---

[15] Although Taxpayer characterizes the test as a "primary purpose" test, the regulation generally does not directly discuss intent or purpose. Certain aspects of the regulation do indicate that a taxpayer's expectations (or at least those that are objectively verifiable) are relevant. See, e.g., section 1.1221-2(c)(1) (risk reduction is determined by all facts and circumstances including "a taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other record.") However, the hedging regulations were promulgated in response to decisions in Arkansas Best v. Commissioner, 485 U.S. 212 (1988) and Federal National Mortgage Ass'n v. Commissioner, 100 T.C. 541 (1993) (Fannie Mae). In both Arkansas Best and Fannie Mae, the courts warned that the use of a subjective motivation test would invite government whipsaw concerns. In Arkansas Best, the Court specifically held that "a taxpayer's motivation in purchasing an asset is irrelevant to the question of whether the asset is 'property held by a taxpayer (whether or not connected with his business).'" Arkansas Best, 485 U.S. 212 at 223 (citing section 1221(a)). Given that government whipsaw concerns would be particularly acute if stated motivations and after-the-fact testimony controlled and given the general absence of "purpose" language in the regulations, courts should evaluate the primary function of a transaction based on objectively determined facts, rather than post-transaction records and expressions of intent that might be colored by hindsight and self-interest.

purchase of the put options is relevant to or precludes treating the call options as entered into primarily to reduce risk. Interpreting section 1.1221-2(b) hedging transaction treatment to hinge on how cash from a transaction is ultimately used or intended to be used would call into question the treatment of heretofore commonly accepted tax hedges that both reduce risk and produce substantial upfront cash flows. For instance, covered written options in a cashless collar, a commonly understood form of business hedging, would invariably be precluded from section 1.1221-2(b) hedging transaction treatment (and exemption from the straddle rules) as the premium on the written call always pays for the purchased put premium. Likewise, written options, written swaptions, prepaid forwards and swaps with significant upfront nonperiodic payments would all be vulnerable to challenge as "intended financings," even though those same transactions would be potentially offsetting positions in a straddle.

Whether paid or received upfront, over time or at the back end of a transaction, the generation of cash flows is often a driving motivation for entering into any hedging transaction. There would be no sound reason for treating transactions that equally reduce risk any differently under the hedging rules simply based on when cash is received and the use of that cash. Moreover, the hedging regulations treat a transaction as a hedging transaction based on whether that transaction reduces risk, not on how cash is used from that transaction to fund *other transactions*. The approach urged by Taxpayer would produce indeterminate and inconsistent results that are directly at odds with Treasury's and the Service's stated intent (and Congressional codification thereof) to cover most common business hedges.

Based upon the foregoing analysis, we conclude that the use of proceeds to fund the purchase of the put options is not relevant to, and certainly does not preclude, the treatment of the call options as being entered into primarily to reduce risk.[16]

Financial Accounting Assertion

Taxpayer makes a similar argument with respect to the restructured contracts. It claims that the "primary purpose" for the written calls, as restructured, was to obtain favorable non-mark-to-market accounting treatment.

---

[16] There are also factual weaknesses in Taxpayer's argument. Taxpayer did not and could not treat the written calls as debt for tax or financial reporting purposes. Although there is factual support for Taxpayer's contention that it entered into the written calls in part to offset the cost of the purchased puts, Taxpayer continued to maintain the call positions well after the purchased puts expired and after their restructuring. There is no evidence that Taxpayer could not have "financed" or that it even considered financing the positions through conventional means. On the other hand, there is ample evidence that Taxpayer contemplated using written calls to hedge future Commodity X sales and that it viewed the restructured contracts as hedges.

Taxpayer was indeed concerned that its mark-to-market financial accounting caused unrealized losses on the written calls to be taken into account currently even though there was no cash impact from Commodity X price increases and the unrealized losses ultimately would be offset by increased profit on its inventory sales. Taxpayer unquestionably modified the written calls in order to claim that it satisfied the FAS 139 "normal sales" exception and improve its financial accounting. Thus, Taxpayer's claim is that the accounting motivation became the "primary purpose," if not the only purpose, for the newly deemed entered contracts that were materially modified under section 1001 (the Counterparty C restructured contracts).[17]

The factual flaw in Taxpayer's position is that it focuses only on the non-economic accounting motivation for the modification, and thereby suggests that the economic risk reducing effects of the transaction are somehow irrelevant. As made clear from Taxpayer's own statements, the written calls, as initially and subsequently structured, had the real economic effect of reducing risk and adjusting the profit that Taxpayer would derive on future anticipated sales of Commodity X. The restructuring of the contracts was done to eliminate accounting distortion and to cause the gain or loss on the restructured contracts to be accounted for at the same time as the profit from the anticipated sales. Taxpayer apparently did not consider it prudent to unwind the transactions at the time of the Year 3 restructuring, and it could have done so at a fraction of the cost that it ultimately incurred in Year 9. Taxpayer knew that any future price changes in the restructured contracts would affect the profitability of its future Commodity X sales. The fact that better accounting could be claimed as a result of the restructuring does not negate the ongoing risk reducing effect of either the original or restructured contracts.

Moreover, financial accounting considerations should no more drive the determination of whether the relevant restructured contracts were primarily risk reducing hedging transactions than they would have if the contracts had been originally entered as restructured. If the terms of the restructured contracts had been entered into in Year 1, there could be no disagreement that the relevant inquiry would be whether the transaction primarily reduced risk. Taxpayer could not legitimately contend that the transaction failed to be a hedging transaction because it was originally styled to achieve favorable accounting treatment from its inception. As such, it would be illogical to give any weight to the subsequent re-styling of the restructured contracts for accounting purposes in assessing whether they were entered into to primarily to reduce risk.

Argument #2: Insubstantial Risk Reduction

[17] Because the hedging transaction determination is made when contracts are "entered into," Taxpayer's argument could only apply to the written calls that were materially modified and deemed newly entered into in Year 3. As discussed above, only the Counterparty A written calls assigned and novated to Counterparty C were materially modified.

Taxpayer also contends that the written calls and restructured contracts did not reduce risk or, alternatively, that the risk reduction was too insubstantial to be considered entered into primarily to reduce risk of price changes under section 1.1221-2(b). Taxpayer claims to have received premium on the written calls equal to approximately n% of the then-current price of Commodity X in Month A/Year 1 and claims the premium on the restructured contracts would have been about l% of the price of Commodity X upon their restructuring in Year 3. Taxpayer more specifically argues that the n% and l% premiums were too insubstantial relative to the upside potential given up to be treated as primarily risk reducing hedging transactions. There is no suggestion by Taxpayer that the written options or restructured contracts were mispriced.

Notwithstanding Taxpayer's claim to the contrary, the additional n% to l% premiums received were material relative to the expected appreciation potential of Commodity X at that time. Taxpayer entered into arm's length arrangements at a point in time when the price of Commodity X was depressed. In hindsight, the premium received looks "irrational" relative to the ultimate appreciation given up. However, the MonthA/Year 1 board presentation demonstrates that Taxpayer was looking to hedge even greater amounts of Commodity X with written calls and forwards, based on information at that time about the market and the d year pricing history of Commodity X. Had the market continued to drop or stayed at depressed levels or within the historic price range cycle that Taxpayer was operating in mid-Year 1, the incremental premium would have proved quite material.[18] The internal and public records reviewed certainly do not evidence that Taxpayer thought the transactions to be irrational, as now claimed. Indeed, Taxpayer advised shareholders in its Year 1 Document that Indirect Quote 5.

---

[18] Taxpayer cited no legal authority for its position that insubstantial risk reduction is not risk reduction, and the hedging rules support the opposite conclusion. In order to be a hedging transaction, section 1.1221-2(b) requires that the transaction reduce risk of interest rate, foreign currency or price changes with respect to ordinary property or liabilities. Unlike the straddle rules, the hedging regulations do not require a specific degree of risk reduction. In fact, the regulations indicate that the degree of risk reduction generally is unimportant. For instance, section 1.1221-2(c)(1)(iv) provides that, "A taxpayer may hedge all or any portion of its risk for all or any part of the period during which it is exposed to the risk." See also section 1.1221-2(e)(3)(iv) (providing that taxpayers should specify the relevant portion of debt being hedged if it is less than the full issue price or the full term of issued or purchased debt) and section 1.221-2(c)(1)(v)(providing that risk counteracting or reversing transactions are treated as hedging transactions even if those counteracting hedges increase risk on an overall basis). Thus, there simply is no legal basis for the claim that hedging treatment requires any specific degree of risk reduction.

The Service and courts have recognized that covered written calls do in fact have a "risk reduction effect" (particularly when long-dated) in other contexts, including under the section 1092 straddle rules. T.D. 8990, 2002-1 C.B. 947 (covered written calls have a "risk reduction effect" which is magnified when the calls are longer-dated and in or closer to being in-the-money); Rev. Rul. 2002-66, 2002-2 C.B. 812 (the inverse relationship between an underlying equity and a short-term written call that was 10% out-of-the money is assumed to substantially diminish the risk arising from holding the equity); Rev. Rul. 80-238, 1980-2 C.B. 96 (written call premium viewed to reduce risk of loss but not sufficiently so under then-governing section 246 standards). Thus, as a legal matter, there is little question that covered written calls have a risk reducing effect.

Taxpayer's written calls, both originally and as restructured, reduced the price risk associated with future Commodity X sales as they reduced Taxpayer's full exposure to Commodity X price movements. In the instant case, Taxpayer was long the Commodity X Ingredient which it processes into saleable Commodity X. As such, the written calls were offsetting positions with respect to the Commodity X and anticipated future sales in that a price decrease in Commodity X increased the value of the written options from Taxpayer's perspective. Similarly, an increase in the price of Commodity X caused the value of the written options to decline from Taxpayer's perspective.[19]

Taxpayer's entering into the written calls had a two-fold risk reduction effect. By reducing its price exposure to Commodity X as part of its board-approved revenue management strategy, Taxpayer reduced its risk of loss but also increased its certainty of return (in the form of the premium received for the written call) in exchange for giving up the uncertain prospects of Commodity X appreciation beyond the relevant option strike prices. The reduced risk of loss provided by the premium (as incremental proceeds on future related Commodity X sales) is somewhat self-evident as any potential loss on the sale of the future Commodity X sales hedged would be reduced by the allocable premium associated with such Commodity X. However, the written calls

---

[19] The Service recognized this same point in the preamble to the final regulations addressing the qualified covered call exception to the straddle rules. T.D. 8990 stated:

> One way of looking at the risk reduction effect of a covered call option focuses on the day-to-day (or intra-day) relative changes in value of the stock and the option. In general, the values of stock and a written call option on the stock vary inversely when viewed from the perspective of the person owning the stock and writing a call option. Each movement in the stock price produces a movement in value of the written call that, at least partially, offsets the change in value of the long position in the stock.

T.D. 8990, supra. That same risk reduction effect occurs with commodities as well as equities.

also provided Taxpayer with an increased certainty of return.[20] That increased certainty of return (and reduced volatility associated with the collective long and short positions) was a function of Taxpayer trading away, through the written option, the highly uncertain potential of Commodity X appreciation beyond expected returns for the more certain enhanced returns coming from the future price plus the premium. In short, Taxpayer reduced volatility by improving the certainty of its expected returns on its future sales of processed Commodity X.

Based upon the foregoing, we conclude that the written calls and restructured contracts primarily reduced risk under section 1.1221-2(b).

Argument #3: Not a Hedge of Inventory Held

Taxpayer also claims that its written calls are not hedging transactions because it did not hold the inventory in processed form, which it anticipated selling in the years covered by the written options. Taxpayer relies on section 1.1221-2(c)(1)(iii) which, after stating that written calls may reduce risk, states, "For example, in appropriate circumstances, a written call option with respect to assets held by a taxpayer…may be a hedging transaction." (emphasis added).

It is undisputed that Taxpayer was long Commodity X and Commodity X Ingredient. In light of this fact, Taxpayer's argument is unpersuasive for three reasons. First, section 1.1221-2(c)(1)(iii) does not require that the Commodity X or other inventory be held or held in a finished state. As expressly stated, the language on which Taxpayer relies is just an example. Section 1.1221-2(b)(1) provides the general rule that a hedging transaction is a transaction that reduces risk of price changes with respect to ordinary property "that is held or to be held by the taxpayer." (emphasis added). The written calls, as restructured, still reduced the risk associated with Taxpayer's fixed long position in Commodity X Ingredient, which was a dominant component in processed

---

[20] The risk reduction standard does not suggest that only risk of loss reduction counts. First and foremost, the hedging regulations do not mention "risk of loss", unlike the counterpart regime for straddles in which substantial diminution of risk of loss is required. Section 1092(c). The examples in the hedging regulations further validate that point. The rules clearly permit interest rate conversion hedges to be treated as hedging transactions. Thus, for example, a taxpayer may convert a fixed rate ordinary debt asset to a synthetic floating rate instrument by entering into a floating-for-fixed swap. That transaction simply adjusts, but does not reduce overall, a taxpayer's risk as the swap merely transforms its loss exposure – instead of being exposed to an economic loss from the drop in value of the debt instrument from an increase in interest rates, a taxpayer becomes exposed to a drop in "effective" interest income upon a decrease in interest rates.

Commodity X it ultimately anticipated holding and selling. Second, the hedging rules are designed to permit the hedging of pricing risks associated with inventory sales and purchases and, as discussed above, are aimed at most common business hedges. That intent would be frustrated if the rules were narrowly construed to permit hedging of only finished inventory on hand. Such an interpretation would preclude some or all long-term inventory-related hedging, where price risk exposure and need for risk management would be all the greater. Third, the regulations clearly contemplate anticipatory hedging, as is typically undertaken with forecasted debt and inventory transactions.

The concept of anticipatory hedging of inventory is well established and deeply rooted in case law. Corn Products Refining v. Commissioner, 350 U.S. 46 (1955) (a corn refiner's hedging of anticipated raw corn purchases was viewed as an ordinary hedging transaction and part of its system of inventory management). In Corn Products, the hedging was undertaken with respect to future raw materials to be acquired. Here, by contrast, the hedging was with respect to future inventory sales. Consistent therewith, Taxpayer's stated position is that the purchased puts reduced the pricing risk associated with anticipated sales of Commodity X, even though the hedge related to Commodity X Ingredient that it anticipated processing to sell in the future – notably beyond the inventory supply that it would have had on hand. It would seem inconsistent with longstanding precedent (and Taxpayer's own position with respect to its purchased puts) if taxpayers were precluded by the written option example from anticipatorily hedging inventory sales. Given the clear intent of the regulations to permit anticipatory hedging, it would be odd if an inclusive example in the hedging regulations was read to exclude hedging transaction treatment for written calls that otherwise satisfy the risk reduction and other requirements of the hedging regulations.

Based upon the foregoing, we conclude that the written calls and restructured contracts were hedging transactions within the meaning of section 1.1221-2(b).

Issue 4: Whether Taxpayer was permitted to take losses on the Year 1 written call options, as restructured, at the time of their closing in Year 9 and, if not, whether Exam's chosen method of accounting for the losses is improperly unlawful or arbitrary?

Section 1.446-4(a) provides that "Except as provided in this paragraph (a), a hedging transaction as defined in section 1.1221-2(b) (whether or not the character of gain or loss from the transaction is determined under section 1.1221-2) must be accounted for under the rules of this section." Apart from those transactions excluded under section 1.446-4(a)(2) (generally section 475 positions and integrated section 1.1275-6 and section 988 transactions), all non-section 1256 transactions that otherwise qualify as hedging transactions under section 1221 must be accounted for under the hedge timing rules of section 1.446-4, even where those transactions have not been properly identified by the taxpayer. Rev. Rul. 2003-127, 2003-2 C.B. 1245.

The section 1.446-4 hedge timing rules were generally promulgated to preclude taxpayers from selectively recognizing built-in losses on hedges, which generally, 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, "Although the 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." Prop. Treas. Reg. § 1.446-4, Fed. Reg. 54077, 54077, 54078 (Oct. 20, 1993).

Section 1.446-4(b) provides that the method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain or loss from the hedging transaction with the income, deduction, gain or loss from the item or items being hedged. Taking gains or losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. For example, where a hedge and the item being hedged are disposed of in the same taxable year, taking realized gain or loss into account on both items in that taxable year may clearly reflect income. In the case of many hedging transactions, however, taking gain and losses into account as they are realized does not result in the matching required by this section.

Section 1.446-4(e) provides further guidance for certain transactions, including inventory sales, but even if those rules are satisfied, the taxpayer's method, as actually applied to the taxpayer's hedging transactions, must clearly reflect income by meeting the matching requirement of section 1.446-(b).

Section 1.446-4(e) provides that if a hedging transaction hedges sales of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss would be an element of sales proceeds. If a hedge is associated with a particular purchase or sales transaction, the gain or loss on the hedge may be taken into account when it would be taken into account if it were an element of cost incurred in, or sales proceeds from, that transaction.

Section 1.446-4(d) provides that the books and records maintained by a taxpayer must contain a description of the accounting method used for each type of hedging transaction. The description must be sufficient to show how the clear reflection requirement of section 1.446-4(b) is satisfied.

Section 1.446-1(a)(2) provides that no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. Section 446(b) provides that if a taxpayer's method does not clearly reflect income then taxable income shall be computed under the method that the Service determines does clearly reflect income. The Service has broad discretion to determine whether a taxpayer's method of accounting clearly reflects income. Once that discretion is exercised, the Service's method is entitled to substantial deference and will be upheld except where the taxpayer can prove that the Service abused its discretion by making an unlawful or arbitrary determination. Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-33 (1979); Am. Fletcher v. United States, 832 F.2d. 436, 438 (7th Cir. 1987). In applying the arbitrary or unlawful standard, the courts are mindful that taxpayers bear the burden of proof and their failure to keep required or adequate records may be considered in evaluating the Service's choice of method. JPMorgan Chase & Co. v. Commissioner, 458 F.3d 564, 571-72 (7th Cir. 2006).

As indicated above, the Year 1 written calls and the Year 3 restructured contracts (whether considered to be materially different or not) were hedging transactions. Taxpayer did not identify the transactions in Year 1, Year 3 or thereafter as hedging transactions. Taxpayer did not identify the hedged items in its tax books and records and did not maintain records of any kind that would sufficiently demonstrate how its realization method of accounting would clearly reflect income by matching income, deduction, gain or loss to the items being hedged.

The record shows that Taxpayer entered into hedging transactions such as forwards and written calls to hedge a small portion of its future anticipated Commodity X production and sales. Taxpayer clearly understood that it is was hedging future inventory sales in Year 10, Year 11 and Year 13 and even considered extending those hedging transactions out further. In its Year 1 Document, Taxpayer described its economic exposure on the written calls as related to future transactions in years in which the European call options were exercisable. Taxpayer stated that Indirect Quote 6.

Taxpayer does not suggest how realization treatment could be justified here under the hedge timing rules. Taxpayer only claims that its loss was sustained, implicitly suggesting that realization treatment satisfies the matching requirement. As mentioned above, while section 1.446-4(b) suggests that realization treatment may be appropriate in certain circumstances, the written calls and restructured contracts were closed out years in advance of the years in which it was hedging its future production and sales. Since the hedge timing rules were expressly promulgated to preclude loss cherry picking and instead force matching of hedge income, deduction, gain and loss to items of income, deduction, gain or loss from the risk that the hedge is adjusting, it is hardly reasonable for Taxpayer to suggest that its method of accounting produced the required matching under section 1.446-4.

Taxpayer alternatively claimed that the losses from the written calls related to inventory sales in the Year 1 through Year 3 years hedged by the purchased puts. That contention is not factually supportable. The vast bulk of the losses from the written calls and restructured contracts arose after the purchased puts were closed and after the Year 1 through Year 3 production was sold. Further, as a factual matter, Taxpayer could not substantiate that the long-dated written calls related to the short-term pricing exposure already addressed by the in-the-money purchased puts. It is inherently unreasonable to view long-term hedges as managing short-term risks given Taxpayer's policy against speculation. Moreover, Taxpayer failed to keep required tax records that demonstrated that it was hedging short-term pricing risks with long-term hedges and its non-tax records show that Taxpayer viewed itself to be hedging Commodity X production years in which the European calls, as restructured, were due to expire.

Based on the above, Taxpayer was not permitted to take losses on the written calls, as restructured, during Year 9. Rather, in order to clearly reflect income under the section 1.446-4 matching rules, those losses should be taken into account, as Exam has proposed, during the same taxable year that the applicable calls were scheduled to expire.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.