Office of Chief Counsel
Internal Revenue Service
Memorandum

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subject:

On December 14, 2014, our office informed you that the offices of the Division Counsel, Large Business and International (LB&I), and the Associate Chief Counsel, Financial Institutions and Products (FIP), considered the issues in this case and determined that Counsel does not support the proposed adjustments disallowing [redacted] This memorandum provides our legal analysis.

DISCLOSURE STATEMENT

[redacted]

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ISSUE

Under the facts of this case, whether the should be disallowed?

CONCLUSION

It is our view that the application of the straddle rules and the resulting disallowance is not appropriate under the facts in this case.

[redacted]

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FACTS

. The VaR methodology was developed in the 90's by JPMorgan, and since then, has been used by most dealers or/and traders in securities, derivatives and commodities.

The VaR is generally measured in dollars and volumes of physical positions.

Examination Team's Position

Taxpayer's Position

LAW

Section 475 and the regulations thereunder provide that dealers and traders in

commodities may elect to apply the mark-to-market provisions of § 475(a). Sections 475(e) and 475(f)(2). In general, the mark-to-market provisions, if elected by a dealer or trader in commodities, require that the gains or losses on any commodity position held at the end of the year by such dealer or trader shall be recognized as if it was sold for its fair market value at the end of the year. In the case of a commodity that is inventory in the hands of the dealer, the commodity shall be included in inventory at its fair market value. A commodity for purposes of § 475 is a commodity which is actively traded (within the meaning of § 1092(d)(1)), any notional principal contract with respect to such commodity, any interest in, or a derivative instrument in, any commodity, including any option, forward contract, futures contract, or short positions, and finally, any position which is not a commodity, but is a hedge with respect to such a commodity that is clearly identified in the taxpayer's records before the close of the day on which it was acquired or entered into. § 475(e)(2).

Under § 475(b) and (e), a dealer in commodities may apply the following exceptions from the mark-to-market rules by clearly identifying certain positions before the close of business day on which they were acquired: (i) as held for investment under § 475(b)(1)(A), (ii) as acquired in the ordinary course of a trade or business and not held for sale under § 475(b)(1)(B), or (iii) as a hedge with respect to a position that is not marked-to-market under § 475(b)(1)(C). Under § 475(f)(1)(B)(i) and (ii), a trader in commodities may only except a commodity from marking if its establishes that the commodity is not held in connection with its activities as a trader and if it timely identifies that commodity in its books and records.

Section 475(d)(1) provides for coordination of this section with certain other rules. Specifically, under § 475(d)(1), the rules of §§ 263(g), 263A and 1256(a) shall not apply, and § 1091 shall not apply (but § 1092 shall apply) to any loss recognized under § 475. This provision, in effect, confirms that taxpayers subject to § 475 mark-to-market, are not exempt from the application of straddle rules.

Section 1092(a)(1)(A) provides that any loss with respect to one or more positions in actively traded personal property shall be recognized only to the extent that the amount of such loss exceeds the unrecognized gain, if any, with respect to one or more positions which were offsetting positions with respect to one or more positions from which the loss arose. A long or short position in a commodity, such as crude oil, gasoline, or a related refined product, is considered to be a position in actively traded personal property for purposes of § 1092. The recognition of the remaining losses is deferred until such time as there is no longer any unrecognized gain in offsetting positions. Under § 1092(a)(3), unrecognized gain means a gain which would be taken into account had the position been sold on the last day of the taxable year at its fair market value, or, in the case of realized but unrecognized gain, the amount of realized gain.

Section 1092(c)(2)(A) provides that the positions are considered to be offsetting if "there is a substantial diminution of the taxpayer's risk of loss from holding any position with

respect to personal property by reason of his holding one or more other positions with respect to personal property." Section 1092(c)(3)(A) provides a presumption that two or more positions will be presumed to be offsetting if the positions are in the same personal property, even though such property may be in a substantially altered form. However, under § 1092(c)(3)(B), such presumption may be rebutted.

Section 1092(d)(4) provides that "in determining whether two or more positions are offsetting, the taxpayer shall be treated as holding any position held by a related person." Related persons include persons filing a consolidated return with the taxpayer, and partnerships, if any part of the partnerships' gain or loss would be taken into account by the taxpayer. Section 1092(d)(4)(B)(ii) and (C).

Section 1092(e) provides an exception from straddle rules for hedging transactions (as defined in § 1256(e)). Section 1256(e) states that a hedging transaction is any "transaction (as defined in § 1221(b)((2)(A)) if, before the close of the day on which such transaction was entered into (or such earlier time as the Secretary may prescribe by regulations), the taxpayer clearly identifies such transaction as being a hedging transaction."

A hedging transaction is one that is engaged in by the taxpayer in the normal course of the taxpayer's trade or business primarily to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer... and to manage other risks as the Secretary may prescribe in the regulations. Section 1221(b)(2)(A).

Treasury Regulation § 1.1221-2(f) provides the rules and recordkeeping requirements related to hedging transactions and their identification. The regulations state, in part, that identification must be made contemporaneously and must identify the item, items or aggregate risk being hedged. The regulations also describe the requirements for identification related to hedges of aggregate risk. These requirements include a description of the risk being hedged and the hedging program under which the hedging transaction was entered into. The regulations state that the above requirements may be met by placing in the taxpayer's records a description of the hedging program and by establishing a system under which individual transactions can be identified as being entered into pursuant to the program. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy the identification requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. Section 1.1221-2(f)(4)(ii).

Section 446(b) provides that if no accounting method has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

Treasury Regulation §1.446-4(d)(1) 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. In addition to the identification required by § 1.1221-2(f), the books and records maintained by a taxpayer must contain whatever more specific identification with respect to a transaction is necessary to verify the application of the method of accounting used by the taxpayer for the transaction. This additional identification may relate to the hedging transaction or to the item, items, or aggregate risk being hedged. The additional identification must be made at the time specified in § 1.1221-2(f)(2) and must be made on, and retained as part of, the taxpayer's books and records.

ANALYSIS

Generally, § 1092(e) exempts hedging transactions (as defined in § 1256(e)) from the application of the straddle rules. Section 1256(e)(2) defines a hedging transaction by reference to § 1221(b)(2)(A). Section 1221(b)(2)(A) defines a hedging transaction as "any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily –

(i) To manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,
(ii) To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or
(iii) To manage such other risks as the Secretary may prescribe in regulations."

See also Treas. Reg. § 1.1221-2(b).

[redacted]

[redacted]

[redacted] The taxpayer in the PLR hedged its exposure to commodity price changes and currency fluctuations with respect to its physical commodity inventory that was accounted for book and tax purposes under LIFO or FIFO method of accounting. The taxpayer entered into forward, futures, swap and option contracts to buy or sell commodities (in the aggregate, referred to as "hedging contracts") and hedged its net exposure between its physical inventory and offsetting hedging contracts. It took "into account its total "long" positions (i.e., physical inventory on hand and contracts to buy commodities) and its "short" positions (i.e., contracts to sell commodities) and, within the designated control limits, enter[ed] into hedging contracts and generally trie[d] to maintain a "balanced" position at the end of each business day." See PLR 9832020, at 2. Under the PLR hedging program, the taxpayer was "unable to determine if any specific hedging contract is a hedge of future purchases, future sale, or physical inventory, or a partial or total offset of a preexisting hedge." Id. The taxpayer in the PLR represented that all of the hedging contracts entered into pursuant to its hedging program met the substantive requirements of a hedging transaction under Treas. Reg. § 1.1221-2(b) and were properly identified under Treas. Reg. § 1.1221-2(e).

[redacted]

Identification Requirement For Hedging Transactions

[redacted]

Treas. Reg. § 1.1221-2(f)(1) provides that a taxpayer that enters into a hedging transaction must clearly identify it as a hedging transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction. Treas. Reg. § 1.1221-2(f)(2) provides that a taxpayer that enters into a hedging transaction must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk and the type of risk that the transaction creates. In addition, the identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this identification requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. Treas. Reg. § 1.1221-2(f)(4)(ii). For hedges of aggregate risk under Treas. Reg. § 1.1221-2(f)(3)(iv), a description of a hedging program must include an identification of the type of risk being hedged, a description of the type of items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified. When transactions that counteract hedging transactions are involved, the description of the hedging transaction must include an identification of the risk management transaction that is being offset and the original underlying hedged item. Treas. Reg. § 1.1221-2(f)(3)(v).

In addition to the identification required by Treas. Reg. § 1.1221-2(f), the books and records maintained by a taxpayer must contain a description of the accounting method used for each type of hedging transaction under Treas. Reg. § 1.446-4(d)(1). The books and records must also include any specific identification with respect to a transaction that is necessary to verify the application of the method of accounting used by the taxpayer for the transaction. This additional identification may relate to the hedging transaction or to the item, items, or aggregate risk being hedged. § 1.446-4(d)(2).

[redacted]

The revenue ruling analyzes a situation where "H" borrows money and enters into a contract to manage the interest rate risk with respect to the loan. "H" does not identify the contract as a hedge pursuant to Treas. Reg. § 1.1221-2(f) and also fails to comply with the identification requirements of Treas. Reg. § 1.446-4(d)(2). The ruling concluded that the fact that the contract was not identified as a hedging transaction did not cause it to fail to be a hedging transaction under Treas. Reg. § 1.446-4(a).

Legislative history of § 1092 –

The legislative history of § 1092 indicates that by adopting the straddle rules in 1981, Congress intended to curb certain abusive commodity transactions. According to the General Explanation of the Economic Recovery Tax Act of 1981:

> [T]he possibility that certain transactions called spreads or straddles might afford taxpayers an opportunity to defer income and to convert ordinary income and short-term capital gain into long-term capital gain had been recognized by the

> investment industry for decades. In the last ten to fifteen years, the use of such tax shelters in commodity futures has extended beyond investment professionals to significant numbers of taxpayers, individual and corporate, throughout the economy. .... [T]he widespread tax sheltering activity threatened substantial disruption in the commodity markets. The tax benefits allegedly available through commodity transactions were leading many taxpayers to engage in transactions that were otherwise uneconomic, with a resulting distortion of supply and demand curves ....

See Staff of the Joint Comm. On Taxation, 97th Cong., General Explanation of the Economic Recovery Tax Act of 1981, at 282-283.

This view about the anti-abuse nature of the straddle rules is widely shared in the tax community:

> The straddle rules function well as anti-abuse rules to prevent the type of transactions they were designed to prevent – that is, tax-motivated, risk-free transactions in publicly traded property entered into for the purpose of accelerating taxable loss, deferring taxable gain, and changing what would otherwise be ordinary income to capital gain. However, they are overbroad. As a result, their application as substantive tax accounting rules can cause taxpayers who engage in legitimate transactions that happen to involve offsetting positions in personal property to be subject to punitive, unintended consequences...

See Jeffrey W. Maddrey and John Kaufmann, 40 Years: Examining the Straddle Rules After 25 Years, 2012 TNT 171-11, at 9.

In a typical straddle, , a taxpayer would establish offsetting positions in the same underlying equity or commodity. The value of these offsetting positions would react inversely to the changes of the market. When the market moves, a taxpayer would incur a loss on one of the offsetting positions, while there would be a more or less equivalent gain on the other offsetting position. A taxpayer may choose to close the loss position while leaving the gain position open until the following year and enter into a replacement position to the one closed to prevent any true exposure to economic risk. In effect, Congress enacted the straddle rules to prevent such selective recognition of artificial losses while deferring gains. [redacted]

In addition, the legislative history of § 1092 reveals the Congressional intent of applying straddle rules consistent with the principle of clear reflection of income. For example, with respect to a situation in which the realized loss on the loss legs of a straddle exceeds the unrealized gain on the gain legs, "[T]he Congress intended that allocation of losses to unrealized gain positions be done in a consistent manner that does not distort income." Id. at 284. Further, with respect to the straddle-by-straddle

identification rules, granting Treasury the authority to promulgate regulations concerning identification requirements, Congress clearly intended these regulations to be consistent with the general tax principle of clear reflection of income: "[Congress] intended that, in applying the regulations to separately identified mixed straddles, the determination by the taxpayer of what constitutes a mixed straddle generally will be accepted by the IRS if the taxpayer has adopted a reasonable and consistently applied method of identifying straddle positions which clearly reflects income in the absence of circumstances indicating that the taxpayer has not properly identified straddles pursuant to such method." H.R. Rep. No. 861, 98th Cong., 2d Sess., 912 (1984).

The Service has previously recognized the need to exercise restraint in applying the straddle rules in certain situations. In FSA TL-N-6746-94 issued in 1994, the Service acknowledged the statutory authority to apply the straddle rules when potentially offsetting positions are involved. However, according to the FSA, "even if the statute could be construed as reserving to the Service the authority to match [offsetting] positions outside of an identified straddle, the legislative history would support taxpayer's argument that the Service must employ a reasonable method which clearly reflects income." The FSA determined that the application of straddle rules on specific facts of the case would not be reasonable and would "not clearly reflect income or the economic realities of the transaction[s]." See 1994 FSA LEXIS 363, at 3.

Although the straddle rules were originally enacted in response to abusive transactions, it is clear that the rules under §1092 as written also apply in non-abusive transactions.

[redacted]

4. Positions held by [redacted] Are Not Offsetting

Section 1092 is applicable to offsetting positions that are actively traded. The offsetting positions are defined as positions that provide "a substantial diminution of the taxpayer's risk of loss from holding" other positions. § 1092(c)(2)(A). [redacted]

[redacted]

[redacted]

5. Whether the application of the straddle rules constitutes a method change.

[redacted]

[redacted]

Generally, a change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. Treas. Reg. § 1.446-1(e)(2)(ii)(a). A "material item" includes "any item that involves the proper time for the inclusion of the item in income or the taking of a deduction." In determining whether timing is involved, generally, the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime income or merely changes the taxable year in which taxable income is reported. See Primo Pants Co. v. Commissioner, 78 T.C. 705, 723 (1982); Knight Ridder v. United States, 743 F.2d 781, 798 (11th Cir. 1984); People's Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969).

An accounting practice that involves the timing of when a material item is recognized and included into income or when it is deducted is considered to be a method of accounting. See General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999); Color Arts, Inc. v. Commissioner, T.C. Memo 2003-95. To establish a method of accounting for an item, one may typically show a pattern of consistent treatment for such item. However, even without it, a method of accounting may exist under the definition in Treas. Reg. § 1.446-1(e)(2)(ii)(a). The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns represents consistent treatment of that item for purposes of Treas. Reg. § 1.446-1(e)(2)(ii)(a). Under the foregoing principles, a consistent practice for determining when a taxpayer recognizes deductions for a type of expense generally constitutes a method of accounting, and a change from one such practice to another generally constitutes a change in the method of accounting.

The determination of the proper time to deduct losses under § 1092 is analogous to the matching rule described in Treas. Reg. § 1.1502-13 which affects the timing of items of income and deduction for consolidated returns. That regulation describes the matching rule for intercompany transactions as a method of accounting. § 1.1502-13(a)(3). In addition, in FSA 201426025, Associate Chief Counsel (IT&A) advised that a change in accounting method occurred when Exam determined that a taxpayer could no longer treat transactions as options. The FSA concluded that the change in the characterization of the underlying items impacted the timing of taxable income by requiring more current recognition of gains and losses rather than deferral of those amounts. It also appears that the application of different provisions of § 1092 may lead to different timing changes of a material item depending on a particular subsection of § 1092 that would be applicable. In contrast to the general straddle rule mandating deferral of losses, the identified straddle rules adopt a capitalization regime that requires a loss on an identified straddle to increase the basis of each offsetting position. § 1092(a)(2)(A)(ii).[5]

[5] See also Mark H. Leeds, Identified and Unidentified Straddles, 2012 TNT 171-11 (September 4, 2012).

[redacted]

6. Whether the deferral of [redacted] under the straddle rules would be consistent with clear reflection of income?

Section 446(b) provides that if no accounting method has been regularly used by the taxpayer, or if the method used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. See also Treas. Reg. § 1.446-1(b)(1).

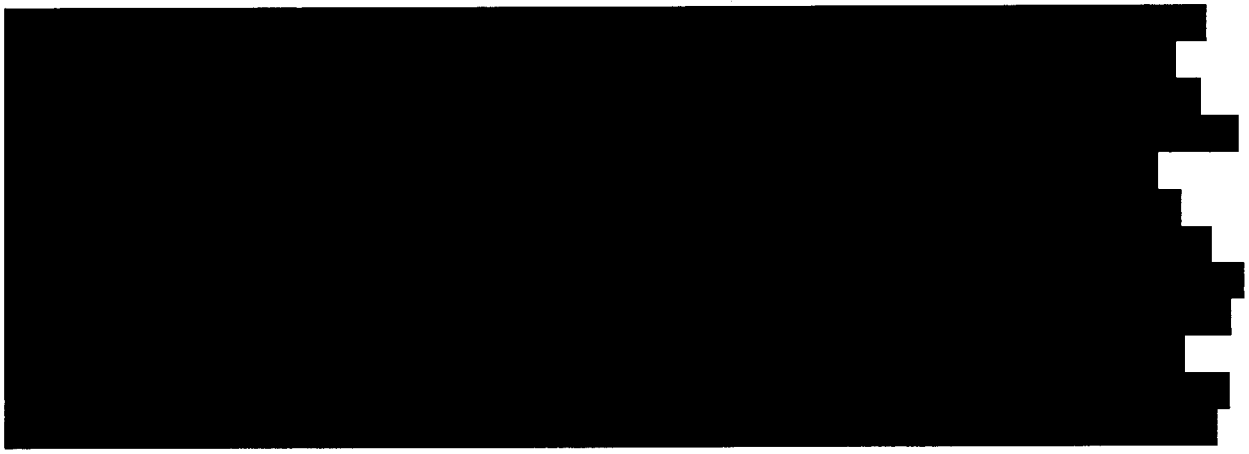
The Commissioner has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. See Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532-3 (1979), RCA Corp. v. United States, 664 F.2d 881, 886 (2nd Cir. 1981), cert denied, 457 U.S. 1133 (1982).

Once the Commissioner has determined that the taxpayer's method of accounting does not clearly reflect income, the Commissioner has broad discretion in selecting a method of accounting that the Commissioner believes properly reflects the income of a taxpayer. The Commissioner's selection may be challenged only upon showing an abuse of discretion by the Commissioner. See Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970); Stephens Marine, Inc. V. Commissioner, 430 F.2d 679, 686 (9th Cir. 1970); Standard Paving Co. v. Commissioner, 190 F.2d 330, 332 (10th Cir.), cert. denied, 342 U.S. 860 (1951).

The Commissioner, however, may not require a taxpayer to change its method of accounting that reflected income clearly just because the Commissioner believes that his method more clearly reflects income. See Louisville and Nashville R.R. v. Commissioner, 641 F.2d 435, 438 (6th Cir. 1981) (to have the authority to change the taxpayer's method of accounting, the Commissioner must meet his burden of demonstrating that the taxpayer's method of accounting did not clearly reflect income), Dayton Hudson Corp. v. Commissioner, 153 F.3d 660, 664 (8th Cir. 1998) (the Commissioner may not require a taxpayer to change from an accounting method that reflected income clearly merely because he believes that her method more clearly reflects income); Ford Motor Co. v. Commissioner, 71 F.3d 209, 213 (6th Cir. 1995) ("It is well established principle that the Commissioner may not invoke her authority under § 446(b) to require a taxpayer to change from an accounting method that clearly reflects income, even if she believes that a second method might more clearly reflect income").

In some cases, despite the fact that the taxpayers were using permissible methods, courts have ruled those methods did not clearly reflect income of the taxpayers and agreed with the Service's change of the taxpayers' methods of accounting. Ford Motor Company v. Commissioner, 71 F.3d 209 (6th Cir. 1996); Mooney Aircraft, Inc. v. United States, 420 F.2d 400 (5th Cir. 1970). In such cases, the courts have looked at the economic realities of the underlying transaction and concluded that the tax reporting of income was so materially different from the timing of reporting economic income and costs, that the taxpayer's method of accounting did not reflect income clearly, although it was technically correct. The materiality of book-tax differences was an important factor for the court in making such determination.

The phrase "clear reflection of income" does not have a precise definition. It is an integral component of the methods of accounting statute. One description adopted by the Tax Court is: "[a] method of accounting will only be deemed to result in a clear reflection of income where it approximates the true economic impact of the taxpayer's transaction during the accounting period." General Dynamics Corp. v. Commissioner, T.C. Memo 1997-420, 1997 (quoting Ford Motor Company v. Commissioner, 71 F3d. 209, 215-216 (6th Cir. 1996)).



[6] Protest, Part III. B. 1.a., page 68.

[redacted]

[redacted]

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HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Please call (281) 721-7351 if you have any further questions.

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