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subject: AMT Preference Item - IDC and Hedging Income

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
A =
B =
C =
D =
E =

ISSUES

Whether Taxpayer may include hedging gains in the calculation of the alternative minimum tax (AMT) preference item for intangible drilling and development costs (IDC) under section 57(a)(2) of the Code. More specifically, whether hedging gains are included in the "aggregate amount of gross income (within the meaning of section 613(a)) from all oil, gas, and geothermal properties of the taxpayer received or accrued by the taxpayer during the taxable year," under section 1.613-3 of the Treasury Regulations.

CONCLUSION

Taxpayer may not include hedging gains in the calculation of the AMT preference item for IDCs under § 57(a)(2). Hedging gains are not included in the "aggregate amount of gross income (within the meaning of section 613(a)) from all oil, gas, and geothermal properties of the taxpayer received or accrued by the taxpayer during the taxable year," under Treas. Reg. § 1.613-3.

FACTS

Taxpayer is an independent energy company engaged in the exploration, development, and production of crude oil, natural gas, and natural gas liquids. Taxpayer has both domestic and foreign operations. Taxpayer explores for and produces oil and gas, but is not involved in transportation, refining or marketing of oil or gas.

Taxpayer hedges a number of units of oil or gas based on its forecasted domestic production. Taxpayer uses several different types of derivative instruments, including swap contracts, floor contracts, collar contracts, and three-way collar contracts. Taxpayer's hedging contracts are settled in cash based on the estimated units, the spot price for the product hedged on the settlement date, and the contracted hedge price. Taxpayer settles hedges only in cash, not by physical delivery. Actual production does not affect the amount of the cash required to settle the hedge contract.

Taxpayer reports that it annually examines its estimates of existing reserves and anticipated production. For Year 2, Taxpayer states that it hedged approximately E percent of its expected Year 3 domestic oil and gas production, excluding natural gas liquids. Taxpayer's hedging policy allows it to hedge up to 100 percent of any anticipated production volumes for any relevant time period for any natural resource commodity it produces or sells. However, Taxpayer's hedging policy explicitly prohibits speculative transactions.

In Year 2, Taxpayer realized net hedging gains with respect to its sales of oil and gas production. Taxpayer timely filed its Year 2 Form 1120, which reported a net loss of \$A. Taxpayer also filed Form 4626, Alternative Minimum Tax – Corporations, which reported an AMT of \$B. Taxpayer later filed a Form 1120X for Year 2 with an amended Form 4626, which reduced the amount of AMT to \$C. Taxpayer reported the reason for the change as recalculated excess IDC by applying §§ 57(a)(2)(B), 57(a)(2)(C) and 57(b) that resulted in reduced excess IDC.

This change was the result of Taxpayer including \$D of hedging gains in the gross income portion of the calculation of net income from oil and gas, in determining the AMT preference item for IDCs for Year 2. Taxpayer's stated basis for doing so was the industry's common practice of using hedges to support drilling programs and to mitigate the risks inherent in commodity production.

Notably, Taxpayer also incurred IDCs in tax years Year 1, Year 3, and Year 4. However, Taxpayer did not include hedging gains and losses in the calculation of its AMT preference item for IDCs in taxable years prior to Year 2. Instead, Taxpayer elected to expense IDCs for those years under §§ 263(c) and 59(a).

LAW AND ANALYSIS

Section 55(a) imposes an AMT equal to the excess of the tentative minimum tax for the taxable year over the regular tax for the taxable year. Section 55(b)(1)(B) states that for corporate taxpayers, the AMT is equal to 20 percent of the Alternative Minimum Taxable Income (AMTI) for the taxable year which exceeds the exemption amount, reduced by the AMT foreign tax credit for the taxable year. Section 55(b)(2) defines AMTI as the taxable income of the taxpayer for the taxable year determined with the adjustments provided in §§ 56 and 58, and increased by the amount of tax preference items described in § 57.

Section 57(a) provides a list of tax preference items for use in determining AMTI. IDCs are included in this list under § 57(a)(2). In general, the amount by which the excess IDC arising in the taxable year is greater than 65 percent of the net income of the taxpayer from oil, gas, and geothermal properties for the taxable year is considered a potential tax preference item.

Section 57(a)(2)(E)(i) provides an exception from the AMTI preference item for IDCs if a taxpayer is an independent producer. The exception states that "this paragraph" [§ 57(a)(2)] does not apply to a taxpayer that is not an integrated oil company as defined in § 291(b)(4). Section 57(a)(2)(E)(ii) qualifies this exception, however. The reduction in AMTI by reason of the exception shall not exceed 40 percent of the AMTI for such year (as determined without regard to the exception and the AMT net operating deduction).

Section 57(a)(2)(B) defines excess IDC as the excess of (i) the IDC paid or incurred in connection with oil, gas, and geothermal wells (other than costs incurred in drilling a nonproductive well) allowable under § 263(c) or § 291(b) for the taxable year, over (ii) the amount which would have been allowable for the taxable year if such costs had been capitalized and straight line recovery of intangibles (as defined in § 57(b)) had been used with respect to such costs.

Section 57(a)(2)(C) defines net income from oil, gas, and geothermal properties as the excess of:

- i. the aggregate amount of gross income (within the meaning of § 613(a)) from all oil, gas and geothermal properties of the taxpayer received or accrued by the taxpayer during the taxable year, over
- ii. the amount of any deductions allocable to such properties reduced by the excess described in § 57(a)(2)(B) for such taxable year.

In the case of mines, wells, and other enumerated natural deposits, § 611(a) allows as a deduction in computing taxable income a reasonable allowance for depletion under regulations prescribed by the Secretary or his delegate.

Section 614(a) provides that, for the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

Section 613(a) provides that "...the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property..."

Further, Treas. Reg. § 1.613-3 provides that in the case of oil and gas wells, "gross income from the property," as used in § 613(c)(1), means the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well. If the oil or gas is not sold on the premises but is manufactured or converted into a refined product prior to sale, or is transported from the premises prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation.

Treas. Reg. § 1.613-3 provides the definition of gross income from oil and gas properties while Treas. Reg. § 1.613-4 provides a similar definition for gross income from mining. Under Treas. Reg. § 1.613-3, gross income from oil and gas is derived only from the sale of these mineral resources. Treas. Reg. § 1.613-4 operates similarly but defines gross income from mining as the income derived from the sale of minerals with some allowance for mining processes. Accordingly, there is a distinction between "gross income from oil and gas properties" and "gross income from mining", with the former being more restrictive.

Section § 1.613-5(a) defines the term "taxable income from the property" as "gross income from the property," as defined in §§ 613(c) and 1.613-4 (*i.e.*, gross income from mining), less allowable deductions (excluding any deduction for depletion) which are attributable to the mineral processes, including mining transportation, with respect to which depletion is claimed.

Legislative History

The AMT preference item for IDCs was first enacted in 1976 as part of a 15 percent add-on minimum tax for individuals. Its purpose was to prevent individuals from taking advantage of oil and gas tax shelters. Congress has amended the AMT preference item for IDCs several times. Each time, Congress retained the reference to the definition of gross income from oil and gas properties found in § 613(a).¹

¹ An allowance for geothermal properties was inserted into § 613(a) by Congress in 1978.

In 1977, Congress amended § 57(a)(11) by inserting the limitation on net income from oil and gas properties.² This amendment provides that the amount of the taxpayer's net income from oil and gas properties is the excess of—(i) the aggregate amount of gross income (within the meaning of § 613 (a)) from all oil and gas properties of the taxpayer received or accrued by the taxpayer during the taxable year, over (ii) the amount of any deductions allocable to such properties reduced by the excess IDCs for such taxable year.” The Conference Report for the 1977 Act explained that, “[i]ncome from oil and gas properties is to be determined in accordance with the rules for determining gross income from oil and gas properties for the purposes of percentage depletion (sec. 613(a) of the Code, without regard to the limitations of sec. 613A).”³

In 1978, Congress extended the effective date of the AMT preference item for IDCs indefinitely while retaining the reference to the definition of gross income from oil and gas properties in § 613(a).⁴ The 1978 Act also extended the availability of the AMT preference item for IDCs to geothermal wells.

In 1986, Congress converted the add-on AMT tax preference for excess IDCs to an AMT preference item for IDCs that applied to corporations and individuals.⁵ Importantly, Congress retained the limitation on net income from oil and gas properties, but adjusted the limitation to 65 percent.

In 1992, Congress “repealed” the AMT preference item for IDCs for independent oil and gas producers, but limited the effect of the “repeal” to no more than a 40 percent reduction in the AMTI computed as if the present excess IDC preference were still in effect.⁶ This was the last amendment to the AMT preference item for IDCs, and it made no changes to the method for determining the amount of net income from oil and gas properties.

The plain language of the statute and legislative history indicate that Congress intended that the aggregate amount of “gross income from all oil, gas, and geothermal properties” for purposes of the AMT preference item for IDCs under § 57(a)(2)(C) be determined by reference to the definition of gross income from the property under § 613(a).

Relevant Case Law

There is no case law that directly addresses the issues presented by this case. However, there is useful case law defining the breadth of “gross income from the property” as provided in § 613(a). The majority of courts that have held that the definition of “gross income from the property” under § 613(a) is limited to proceeds received from the sale of minerals produced from the property. Notably, many of these cases involve coal rather than oil and gas, because § 613(a) applies to both categories

² Tax Reform and Simplification Act of 1977, Pub. L. 95-30, § 308, 91 Stat. 126 (May 23, 1977).

³ H.R. Conf. Rep. 95-263, 95th Cong., 1st Sess. 1977 (at page 30).

⁴ Energy Tax Act of 1978, Pub. L. 95-618, § 402(b), 92 Stat. 3174 (November 9, 1978).

⁵ Tax Reform Act of 1986, Pub. L. 99-514, § 701(a), 100 Stat. 2085 (October 22, 1986).

⁶ Energy Policy Act of 1992, Pub. L. 102-486, Title XIX, §1915 (b)(1), 106 Stat. 3024 (October 24, 1992).

of extracted natural resources. However, the rationale used to narrowly define "gross income from mining" applies to further restrict the definition of "gross income from oil and gas properties".

In *Helvering v. Mountain Producers Corp.*,⁷ the Supreme Court considered whether a taxpayer's gross income from an oil property used to compute the taxpayer's allowance for depletion included both cash payments received from the sale of the oil produced at the property and the amount of operating expenses borne by a third party to produce oil at the property.⁸ The Supreme Court held that the taxpayer's gross income from the property was limited to the cash payments it received from the sale of oil produced by the property. In so ruling, the Supreme Court explained,

The term 'gross income from the property' means gross income from the oil and gas ..., and the term should be taken in its natural sense. With the motives which lead the taxpayer to be satisfied with the proceeds he receives we are not concerned. If, in this instance, the development operations had failed to produce oil, it would hardly be said that the expense of drilling, borne under contract by another, constituted 'gross income' of the taxpayer within the meaning of the statute. Nor, when oil or gas is produced, does the statute base the percentage on market value. The gross income from time to time may be more or less than market value according to the bearing of particular contracts. We do not think that we are at liberty to construct a theoretical gross income by recourse to the expenses of production operations.⁹

Similarly, in *Monroe Coal Mining Co. v. C.I.R.*,¹⁰ the Tax Court considered a case involving the correct computation of the allowance for the percentage depletion deduction based on an interpretation of the term "gross income from the property."¹¹ The taxpayer sought to include the sales proceeds of discarded equipment and discounts received for prompt payment for new equipment within gross income from the property for purposes of computing its allowance for percentage depletion. In limiting "gross income from the property" to the sales proceeds of the mineral produced by the property, the Tax Court noted that for purposes of the statute, "[g]ross income from the property' is to be strictly construed, and is not subject to the nice adjustments recognizable in computing income for the general purposes of the act."¹²

⁷ 303 U.S. 376 (S. Ct. 1938).

⁸ While the concept of the statutory allowance for depletion remains the same, this case cites to a prior statutory provision at §§ 204(c)(2), 234(a)(8) of the Revenue Act of 1926, 44 Stat. 14, 41. This provision is substantially similar to current § 611.

⁹ 303 U.S. at 382 (citation omitted).

¹⁰ 7 T.C. 1334 (1946).

¹¹ This case cites to a prior statutory provision for the allowance for depletion at § 114(b)(4) of the Internal Revenue Code, as amended by § 124(c) of the Revenue Act of 1943. This provision was substantially similar to current § 611. Additionally, the definition of the term "gross income from the property" contained within this provision is cited as § 114(b)(4)(B) of the Internal Revenue Code, as amended by § 124(c) of the Revenue Act of 1943.

¹² 7 T.C. at 1336.

Similarly, in *Guthrie v. United States*,¹³ the Court of Appeals for the Sixth Circuit examined whether the taxpayer could treat proceeds from business interruption insurance as “gross income from mining” for purposes of computing its allowance for percentage depletion. Fires interrupted taxpayer’s mining business, and taxpayer received proceeds from business interruption insurance covering the property. The Court rejected taxpayer’s view that “‘gross income from mining’ includes money received as compensation for the inability to market its coal at a higher price than actually received.”¹⁴ The Court emphasized that only sales proceeds constitute gross income from mining. Further, the Court noted that “the depletion deduction is based on the income derived from the mineral product in its commercial marketable form.”¹⁵ The Court concluded that insurance proceeds are not includible within “gross income from the property”, in this case, “gross income from mining” by reasoning that,

Had this taxpayer not had the foresight to carry business interruption insurance, its total gross income from mining would have been the amount it received for the coal it was able to mine and market, doing the best it could with its impaired operating ability. That this taxpayer avoided such a consequence by carrying insurance does not make the insurance proceeds a part of the price which the taxpayer received for its coal.¹⁶

While one could draw an analogy between the insurance in *Guthrie* and the insurance-like qualities of hedging transactions, the more significant point of *Guthrie* is the Court’s insistence that “gross income” from mineral property is limited to actual sale price.

In a case applying Louisiana law, the Court of Appeals for the Fifth Circuit recently rejected a lessor’s attempt to treat hedging gains as part of the market value of the oil and gas produced from a property subject to a mineral lease. In *Cimarex Energy Co. v. Chastant*,¹⁷ the Court considered whether hedging gains should be included when determining royalties due to a lessor. The lessor claimed that the royalty should be based not only on the market value of the oil and gas produced from the property, but also on amounts Cimarex generated from separate hedging transactions intended to protect against price fluctuations for oil and gas production. Under the language of the lease and longstanding Louisiana law, the Court determined that the lessor’s royalties were limited to the market value of the natural gas or crude oil at the mouth of the well or in the field where it is produced. The Court determined the Cimarex’ hedging transactions were separate and distinct from the production of natural gas or crude oil. The Court observed that,

The hedging activities are used to minimize the risk of market fluctuations in the price of the oil or gas. Because the transactions are purely financial and do not affect the market value of the oil or

¹³ 323 F.2d 142 (Ct. Appeals, 6th Cir. 1963).

¹⁴ *Id.* at 145.

¹⁵ *Id.* at 146. *citing* U.S. v. Cannelton Sewer Pipe Co., 364 U.S. 76, 86 (1960).

¹⁶ *Id.* at 146.

¹⁷ 537 F. App’x. 561 (5th Cir. 2013).

gas at the well or on the leased property, the profits or losses resulting from these transactions are not subject to the royalty provisions in the lease.¹⁸

While the focus of the *Cimarex* case is not on the interpretation of the term "gross income from the property" under § 613, this case demonstrates the traditional commercial understanding of what is treated as income from an oil and gas property. This interpretation limits such income to the sales price of the extracted minerals. It does not include gains derived from separate financial trading activities such as hedges used to minimize business risks. These hedging activities are purely financial and do not impact the income derived from selling the extracted minerals. Accordingly, hedging income should be excluded from "gross income from the property" when calculating the amount of the AMT preference item for IDCs under § 57(a)(2).

Conversely, in *Amherst Coal v. United States*,¹⁹ a West Virginia District Court addressed, among other issues, whether the taxpayer could include settlement proceeds received from a breach of contract as part of its "gross income from mining" for depletion purposes.²⁰ The taxpayer had a contract to sell a fixed amount of coal to a third party, Dillon, for a set amount per ton for three years. Taxpayer had coal available to satisfy the contract, but Dillon refused delivery of some of the coal, which led to a lawsuit between the taxpayer and Dillon. Taxpayer sold the refused coal to another party for a lower amount. The suit was settled for an amount that put the taxpayer in the same position as if Dillon had not breached the contract. The Court held that the settlement amount was "in legal effect part of the sale price for the coal actually extracted. As such it was properly includable in Amherst Coal's 'gross income from mining' for the purpose of computing the percentage depletion allowance."²¹

In response to the *Amherst Coal* decision the Service published an Action on Decision in which it stated that the definition of gross income from mining "explicitly includes the extraction of ore from the ground and certain treatment processes normally applied to the ore. On the basis of the definition provided by the Code, the court erroneously held the proceeds from the settlement to be 'gross income from mining.'"²²

Published Guidance

The Service's longstanding position has been that "gross income from the property" is limited to sales proceeds of the minerals extracted from the property. In TAM 7502099360A,²³ the Service considered whether settlement proceeds received for breach of contract can be included in gross income from mining for depletion purposes. The taxpayer, a mining company, entered into a contract with an unrelated purchaser to

¹⁸ 537 F. App'x. at 565.

¹⁹ 295 F.Supp. 421 (S.D. W.Va. 1969).

²⁰ This case cites to a prior statutory provision for the allowance for depletion at § 114(b)(4) of the 1939 Internal Revenue Code. This provision was substantially similar to current § 611.

²¹ 295 F.Supp. at 445.

²² IRS AOD, 1970 WL 22817 (1970) *citing* *Guthrie v. U.S.*, 323 F.2d 142 (Ct. Appeals, 6th Cir. 1963).

²³ 1975 WL 39263 (February 19, 1975).

sell a specified percentage of the total production from its mines during three consecutive years. After the second year, the purchaser refused to accept further deliveries and the taxpayer subsequently sold the extracted minerals under arms-length purchase contracts to other purchasers at lower prices than would have been realized under the contract. As a result of legal action, the taxpayer received a settlement from the original purchaser based on the difference between the reduced prices at which taxpayer was able to sell its minerals to third parties and the prices it would have been paid under the original contract. The taxpayer then contended that the settlement proceeds should be included in gross income from mining for depletion purposes. The Service reasoned that "the depletion allowance is based upon gross income from mining which is all or part of the income actually received from the actual sales rather than from a hypothetical income that could have been received from sale of the mineral product."²⁴ In this case, gross income from mining is determined with respect to only the amount received on the actual sales of minerals resulting from arms-length purchase contracts.²⁵ Therefore, the settlement proceeds are not payment for the mineral and are not includible in gross income from mining.

The Service has also ruled that futures contracts used by a minerals producer do not give rise to gross income from the property. In GCM 38152²⁶ the Service considered whether gross income from the property includes amounts received by a mining company when futures contracts for the metal it produces are closed without delivery of the metal. The GCM determined that the taxpayer uses futures contracts as a hedge because the income (or spread) received or paid by the taxpayer as a result of closing the futures transactions without delivery of the contracted metals is in lieu of performance under the contract. Therefore, the amount received or paid is the result of an alternative action or form of settlement and the income received by the taxpayer from the futures transaction is not from the sale of the metal produced by the taxpayer. Accordingly, the income is not attributable to the extraction of ores or minerals from the ground and is not includible in gross income from mining for purposes of computing the percentage depletion under § 613.

The GCM also discussed the principal provided in *Guthrie* that hedges in futures transactions are common trade practices and are generally regarded as a form of insurance necessary to conservative business practices.²⁷ Additionally, the GCM states that in this respect, the present case is analogous to the *Guthrie* case. As discussed above, in *Guthrie*, the Court of Appeals for the Sixth Circuit held that proceeds received from business interruption insurance could not be included in gross income from mining under section 613(c). The *Guthrie* court stated that the depletion deduction is based on the income derived from the mineral product in its commercially marketable form.²⁸

²⁴ *Id.*

²⁵ See also GCM 36730, 1976 WL 39001 (May 1, 1976) also cited as Rev. Rul. 77-57 (Service considered whether under § 613(c) gross income from mining includes money received by a mining company in settlement of a judgment against the buyer for breach of a mineral purchase agreement. Service held that such money is not gross income from mining under § 613(c).)

²⁶ GCM 38152, 1979 WL 52908 (October 31, 1979).

²⁷ *Id.* at 5 citing *Guthrie v. U.S.*, 323 F.2d at 143.

²⁸ *Id.*

Importantly, GCM 38152 draws the following comparison between business interruption insurance and commodities hedges:

Although the risks against which business interruption insurance and hedges seek to protect are different, we believe the above quoted analysis is equally applicable here: that the taxpayer in the subject case had the foresight to trade in futures contracts to offset losses on the sale of its metal does not make amounts received when the contracts are closed a part of the price the taxpayer receives for its metal.²⁹

GCM 38152 concludes that gross income from the property “is to be narrowly interpreted, and is limited to amounts received from the severance and sale of the ore or mineral.”³⁰ Further, because “the sale of a futures contract is a sale of rights to the commodity, and not a sale of the commodity itself, amounts received when futures contracts are closed without delivery of the underlying commodity produced by the taxpayer are not includible in ‘gross income from the property’ under section 613(c).”³¹

Similarly, in IRS Advice Memorandum 2009-08 (AM 2009-08),³² the Service considered the issue of whether hedging gains or losses may be included in the calculation of gross income from mining used to compute the allowance for percentage depletion deduction under § 613(a) and § 1.613-4. Certain parts of the discussion in the AM 2009-08 deal with mining processes that do not apply in the oil and gas context. However, § 1.613-4, which provides a definition of gross income from mining for depletion purposes, is in most respects parallel to the rules in § 1.613-3, which provides a definition of gross income from the [oil or gas] properties for depletion purposes. The mining rules look to actual sales of the minerals to derive gross income from mining, but, due to the nature of mineral extraction, allow for a the application of specified “mining processes” before sale. By contrast, the rules for deriving gross income from oil and gas properties, found in § 1.613-3 takes into account only the sales of oil and gas in the vicinity of the well. Accordingly, § 1.613-4 applies a broader meaning of the term gross income from mining than the meaning of gross income from oil and gas properties found in § 1.613-3.

AM 2009-08 states that generally the Service has described hedging transactions as a form of insurance.³³ The discussion quotes the rationale of the *Corn Products* case in providing that “[h]edges, which eliminate speculative risks due to fluctuations in the market price of a particular commodity, are common trade practices and are generally regarded as a form of insurance necessary to conservative business operations.”³⁴ AM 2009-08 points out that in the mining context, § 1.613-4(b)(1) defines “gross income from mining” as “the actual amount for which the mineral is sold if the

²⁹ GCM 38152 at 5.

³⁰ *Id.*

³¹ *Id.*

³² IRS AM 2009-08, 2009 WL 2914291 (2009).

³³ *Id.* citing Rev. Rul. 74-223 1974-1 C.B. 23.

³⁴ *Id.* quoting *Corn Products Refining Company v. C.I.R.*, 350 U.S. 46 (1955).

taxpayer sells the ore or mineral ... after application of only mining processes.”³⁵ As a result, gains or losses generated by hedging transactions are not included within the calculation of gross income from mining under § 1.613-4.

Further, AM 2009-08 observes that § 1.613-5 (a) narrowly defines “taxable income from the property” as “gross income from the property,” as defined in § 613(c) and § 1.613-3 (*i.e.*, gross income from oil and gas properties) and § 1.613-4 (*i.e.*, gross income from mining), less all allowable deductions (excluding any deduction for depletion) which are attributable to mining processes, including mining transportation, with respect to which depletion is claimed. Because taxable income from the property begins with gross income from mining (or gross income from oil and gas properties) and allows only those deductions attributable to mining processes, the obvious intent of the regulations is to narrowly define taxable income from the property just as they narrowly define gross income from mining. Accordingly, AM 2009-08 also concludes that because hedging transactions are a form of price insurance and insurance is not an allowable deduction attributable to mineral processes within the meaning of 1.613-5(a), gains or losses from hedging transactions are also not taken into account in computing taxable income from the property under § 1.613-5.

In CCA 201722028,³⁶ the Service addresses issues similar to those presented by this case.³⁷ The CCA notes that the purpose of determining gross income from the property under § 613(a) is to calculate the depletion allowance under § 611, taking into account only the oil and gas extracted and sold from that property. The CCA notes that the right to oil or gas conveyed in a hedging transaction does not equate to the actual oil and gas produced by a taxpayer *from the property*. The statutory definitions relevant here make clear that “gross income from the property” relates to specific oil or gas from a specific well. Therefore, a hedging transaction has “no connection to the amount for which the taxpayer sells the oil or gas in the immediate vicinity of the well” and accordingly, does not qualify as “gross income from the property” within the meaning of § 1.613-3. The CCA further notes that the purpose of the limitation under § 57(a)(2) is to limit for AMT purposes the amount of deductible IDCs to a percentage of the gross income produced by the properties generating those IDCs. Therefore, “it would make no sense to measure the amount of the IDCs considered ‘excess’ by a calculation including hedging transactions not related to the oil and gas properties of the taxpayer.”³⁸

³⁵ Mining processes are narrowly defined in the regulations to include only specified actions. Treas. Reg. § 1.613-4(f)(2). The inclusion of these processes in gross income from mining is further restricted because even processes that would constitute mining processes if performed by the mine owner or operator, are not mining processes if performed on purchased ores or minerals. As a result, the application of these processes to purchased ores, minerals, or materials does not constitute mining and cannot be included in the computation of gross income from mining. Treas. Reg. § 1.613-4(f)(2)(iv).

³⁶ 2017 WL 2385720 (June 2, 2017).

³⁷ CCA 201722028 does not contain a summary of the facts or issues presented so it is difficult to understand and apply the rationale of this guidance.

³⁸ *Id.*

Conclusion

The hedging gains Taxpayer seeks to include in “gross income (within the meaning of § 613(a)) from oil and gas properties” do not derive from sales in the oil patch. These gains come from derivative contracts – swaps, floors, collars, and other derivative contracts – entered into with investment bankers and other financial counterparties. The hedging gains do not represent the amounts Taxpayer would receive from selling its oil and gas in the field. For instance, the gains on the Taxpayer’s natural gas swaps – its most widely used derivative – are based on the amount by which a negotiated fixed price exceeds the market price for natural gas on the settlement date. The hedging gains from the swaps, thus, are more closely associated with correctly identifying the trend of natural gas prices rather than the actual sales proceeds Taxpayer would receive from selling its natural gas in the vicinity of the well.

The plain language of the Code and regulations, case law, and administrative interpretations all support the Service’s position. None of the authorities Taxpayer may cite for integrating gains or losses from a hedge with gross income from oil and gas properties relates to § 57 or § 613. None of these authorities provides any basis for rejecting the specific and long-established narrow definition of gross income from the property. None of these authorities even mentions the statutes and regulations that control here.

The relevant law in this area is not about the relationship of hedging to the taxpayer’s business, but about its income from oil and gas property. Taxpayer’s approach would reject the statutory and regulatory language, and disrupt long-accepted understanding of § 613(a) and the regulations thereunder. The term “gross income from the property” has historically been limited to the sales proceeds received for oil and gas from the property. The Service believes that courts will follow established precedent in this area. Taxpayer has offered no rationale for rejecting the statutory language in § 57(a)(2)(C) (that requires the determination of gross income from oil and gas properties by reference to § 613(a)), or for rejecting the courts’ and the Service’s longstanding interpretation of § 613(a).

Relying on the rationale of AM 2009-08, the Service takes the position that Taxpayer may not include hedging gains or losses in the calculation of gross income from the properties or in the calculation of net income from the properties. Therefore, Taxpayer also may not include hedging gains or losses in gross income from the properties when calculating its AMT preference item for IDCs under § 57(a)(2) for Year 2.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Taxpayer has not provided detailed legal support for its position, but other taxpayers taking a similar return position have argued that various legal authorities support including hedging gains in the calculation of gross income from oil and gas properties. The authorities that taxpayers cite to support inclusion of hedging gains in

income are inapplicable to determining gross income from oil and gas properties. None of these authorities involves the definition of gross income from oil and gas properties under § 613(a). The argument for inclusion appears to be that because the use of hedging transactions is commonplace in the industry as a necessary protection against commodity price fluctuations, it should be included in gross income from the property.

Taxpayers typically cite *Corn Products Refining Company v. C.I.R.*³⁹ for the principal that futures transactions serve as an integral part of a taxpayer's underlying business and therefore hedging income is includible in "gross income from the property."⁴⁰ Specifically, the Supreme Court held that the futures contracts were integral to the taxpayer's inventory purchase system and since inventory was an exception to capital asset treatment under § 1221(a) then the gains realized from closing the corn futures contracts should receive ordinary treatment.⁴¹ Importantly, this decision only addressed the character of hedging income. Taxpayers have taken an expansive view of this holding to assert that hedging transactions may be considered an integral part of a taxpayer's operation to produce oil or gas. Consequently, taxpayers assert that under the *Corn Products* rationale, net hedging gains are essentially "gross income from the property." However, the *Corn Products* case is entirely unrelated to the determination of "gross income from the property" under § 613(a).

Another case taxpayers cite in support of integrating hedging income with the activity to which it relates is *Arkansas Best Corp. v. C.I.R.*⁴² In *Arkansas Best*, the taxpayer claimed that losses on certain bank stock should be treated as ordinary income.⁴³ The taxpayer claimed the stock was not a capital asset, since it was acquired and held exclusively for business purposes rather than as an investment.⁴⁴ The Supreme Court rejected this position and relying upon the *Corn Products* rationale, held that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exception of § 1221.⁴⁵ Accordingly, the Court stated that taxpayers may rely on *Arkansas Best* to argue that hedging transactions can be viewed as "surrogates" for gross income generated from the production of oil or gas, and consequently, should be treated the same as "gross income from the property."⁴⁶ However, like *Corn Products*, *Arkansas Best* provides no insights into the meaning of "gross income from the property" as defined in § 613(a) for depletion purposes.

In a more attenuated argument, the Taxpayer might also cite *Monfort of Colo., Inc. v. C.I.R.*,⁴⁷ to support an "integration" argument. The Court in *Monfort* held that the hedging transaction gains and losses were a cost of acquiring cattle. By analogy, one might argue that hedging transactions are part of the sales proceeds from the oil produced by Taxpayer. Again, while the case offers an analogy to Taxpayer's situation

³⁹ 350 U.S. 46, 1955-2 C.B. 512 (1955).

⁴⁰ *Id.* at 50.

⁴¹ *Id.* at 54.

⁴² 485 U.S. 212 (1988).

⁴³ *Id.* at 214.

⁴⁴ *Id.* at 214-15.

⁴⁵ *Id.* at 222.

⁴⁶ *Id.*

⁴⁷ 561 F.2d 190 (10th Cir. 1977), *aff'g.* 406 F.Supp. 701 (1976).

that is appealing initially, Congress has clearly chosen a different, more limited framework for defining "gross income from the property" for purposes of Taxpayer's situation.

Alternatively, the Taxpayer may contend that § 1.446-3 supports treating hedging gains as gross income from oil and gas property. Section 1.446-4(e)(3)(i) provides that gains and losses from hedging transactions are to be treated as components of the related inventory or sales proceeds. By analogy, the Taxpayer may argue that net hedging gains should be treated as sale proceeds from oil or gas and therefore are includible as "gross income from the property." However, the same flaw appears in this argument as in the others discussed above. None of the authorities Taxpayer may cite for integrating a hedge with gross income from oil and gas properties relates to § 57 or § 613. None of these authorities provides any basis for rejecting the specific and long-established narrow definition of "gross income from the property" chosen by Congress and recognized by the IRS and courts. In fact, none of these arguably analogous authorities even mentions the statutes and regulations which control here.

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