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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: LON B. SMITH
ACTING ASSOCIATE CHIEF COUNSEL (FINANCIAL INSTITUTIONS AND PRODUCTS) CC:FIP

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated April 23, 2001. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND:

Taxpayer =

Years =

Country X =

w =

y =

z =

ISSUES:

1. Whether the hedging rules, if applicable, would alter the time for recognition of income by Taxpayer on its long-term sales contracts?

2. Whether the entire sales price paid by the to Taxpayer on the long-term sales contracts is "gross income from mining" for depletion purposes under section 613 of the Internal Revenue Code?

3. Whether the entire sales price paid by the to Taxpayer on the long-term sales contracts is foreign trading gross receipts (FTGR) for purposes of the foreign sales corporation (FSC) rules?

CONCLUSIONS:

1. The hedging rules, if applicable, would not alter the time at which income would be earned by Taxpayer on its sales contracts.

2. Because Taxpayer does not sell its mineral after only mining processes, it must generally calculate its depletion deduction based on a Representative Market or Field Price, where such can be established.

3. So long as the full sales price of the sold under the contracts is considered amounts realized under section 1001 from the sale of property, Taxpayer may treat such proceeds as FTGR in determining FSC benefits.

FACTS:

During Years under audit, Taxpayer, a U.S. subsidiary of a Country X based producer, had long-term contracts in place that called for Taxpayer to sell part of its anticipated production to a number of major [redacted] banks. These contracts provided for delivery of a maximum specified amount of over w or more years. The agreed to pay a price for the that was based on the price of at the inception of the applicable agreement plus " ." was an addition to purchase price that was determined by multiplying the price of on the date of the contract times an interest rate and then subtracting a variable cost, determined by multiplying a times the price of at the beginning of each accrual period as defined by the parties. At the end of each accrual period, would offer new interest and that varied based on the alternative accrual periods offered. Taxpayer could choose to deliver some or all of the covered by the agreement or it could continue to defer the sale and delivery by accepting one of a newly offered rates and accrual periods.

During the audit Years, Taxpayer continued to defer delivery of a substantial quantity of covered by the contracts. The contracts proved quite profitable to

Taxpayer. prices generally declined during this period while Taxpayer benefitted from the higher locked-in and accruals.

In total, the contracts accounted for about y years of Taxpayer's expected production and about z percent of its in-the-ground ore reserves. Taxpayer identified the contracts as hedging transactions for federal income tax purposes. It designated dates on which it expected to make deliveries under the agreements and generally delivered on the designated dates.

Taxpayer exports the and pays its wholly-owned FSC (as defined under sections 921 and 927(f)(1)) a commission on the sales using the administrative pricing rules of section 1.925(a)-1T(c)(3) (combined taxable income method). Taxpayer and its FSC determined the commission based upon the total amount of receipts received under the long-term contracts. Thus, Taxpayer treated the total amount of receipts as FTGR. We assume, except for this issue, that all other FSC requirements for the receipts to qualify as FTGR have been met.

LAW AND ANALYSIS:

Hedging

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over its adjusted basis provided in section 1011. The amount realized under section 1001(b) is the sum of money received plus the fair market value of the property (other than money) received.

Section 1.1221-2(b) defines a hedging transaction, in part, 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. Section 1.446-4 provides exclusive rules prescribing the method of accounting for hedging transactions. Under section 1.446-4(b), the method of accounting used by a taxpayer for a hedging transaction must clearly reflect income, meaning the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. Section 1.446-4(e)(3) generally provides that gain or loss from hedging sales of inventory may be taken into account as if the gain or loss were an element of sales proceeds.

The timing of Taxpayer's recognition of income on the contracts is not impacted by whether the contracts are properly treated as hedging transactions.[1] Section 1.446-4(b) requires a reasonable match of the income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the hedged item. For the hedged sale of inventory, gain or loss on the hedge is generally taken into account as an element of sales proceeds. In Taxpayer's situation, the hedging regulations, even if applicable, do not require gain on the long-term contracts to be recognized any earlier than at the time of the sale of the underlying .

<u>Depletion</u>

Section 611(a) provides an allowance for depletion in the case of mines, oil and gas wells, and timber. Section 612 provides for the use of cost depletion while section 613(a) provides for the use of percentage depletion. Under section 613(a), the greater of cost or percentage depletion must be used.

Percentage depletion is calculated under section 613(a) by multiplying the taxpayer's Gross Income From Mining (GIFM) by the appropriate percentage rate in section 613(b). If the taxpayer sells its mineral after the application of only mining processes, its actual sales price is its GIFM. Section 1.613-4(b). If the taxpayer makes no sales after only mining processes, sales by other producers of the same mineral after only mining processes are applied are used to establish a Representative Market or Field Price (RMFP) which may not exceed the actual sales price of the taxpayer's mineral. Section 1.613-4(c). If there are no actual sales at the end of mining or a RMFP, the taxpayer calculates its GIFM by the proportionate profits method in which the ratio of the taxpayer's mining costs to total costs is multiplied by the income the taxpayer receives for its manufactured product. Section 1.613-4(d).

Taxpayer does not sell its mineral after only mining processes; therefore, Taxpayer must use a RMFP if one exists. Our discussions with the examiners indicate a RMFP can be established for Taxpayer's mineral sales. Assuming a RMFP exists, Taxpayer's percentage depletion deduction is calculated using the RMFP provided that the price does not exceed the actual sales price of the mineral. The deduction is computed at the time that Taxpayer properly includes the sales proceeds in income under its method of accounting.

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[1] Taxpayer has suggested that its contracts were not hedges and that its identifications as such were made with an excess of caution. We do not have to, and do not, determine here whether the contracts were hedges for tax purposes; however, we are sympathetic to Taxpayer's view that the transactions were not hedges.

Foreign Trading Gross Receipts

A FSC receives certain tax benefits under sections 921 through 927. These benefits are determined with respect to FTGR. FTGR include gross receipts of a FSC from the sale of export property. Section 924(a)(1). FTGR also include gross receipts of a principal from the sale of export property where a FSC acts as a commission agent with respect to such sale. Section 1.924(a)-1T(b). Export property includes property manufactured, produced, grown, or extracted in the United States by a person other than a FSC and held for sale in the ordinary course of trade or business by, or to, a FSC for direct use, consumption, or disposition outside the United States and not more than 50 percent of the fair market value of which is attributable to articles imported into the United States. Section 927(a)(1)(A). A FSC commission that is calculated using the combined taxable income method under section 925(a)(2) equals 23% of the combined taxable income of the FSC and the related person attributable to FTGR derived from the sale of export property. Thus, a FSC's tax-favored commission (and the related U.S. exporter's corresponding commission deduction) increases as FTGR increases.

Whether the deferred payments at issue constitute FTGR depends on whether they are "gross receipts." "Gross receipts" include total receipts from the sale of property held primarily for sale in the ordinary course of business. Sections 927(b)(1)(A); 1.927-(b)-1T(a)(1). A similar definition applies for a commission FSC. Section 927(b)(2). In contrast, investment income, such as interest, gains from the sale or exchange of stock or securities, and gains from certain futures transactions (other than gains which arise out of a bona fide hedging transaction reasonably necessary to conduct the business of the FSC in the manner in which such business is customarily conducted by others), do not constitute FTGR. See sections 924(a) and 927(c). Accordingly, in the FSC context, gross receipts include the amount realized by Taxpayer on its sale of export property.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Because the hedge timing rules will not affect whether [redacted] or any other time value component accrued prior to sale of the [redacted] under the contracts, no opinion was expressed on whether the long-term contracts constitute hedging transactions.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

We would be pleased to provide ongoing assistance as this case develops. Please call Patrick White at 202-622-4016 if you have any further questions.

ALVIN J. KRAFT
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Office of Associate Chief Counsel
(Financial Institutions & Products)