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From:
Sent: Tuesday, September 02, 2008 1:31:33 PM
To:
Cc:
Subject: Hedging -- Inadvertent Error and Anti-Abuse Rule Interaction

This responds to your request for our views on the interaction between the inadvertent error rule of section 1.1221-2(g)(2)(ii) and the anti-abuse rule of section 1.1221-2(g)(2)(iii) of the hedging regulations. Your inquiry arises from a situation in which the Service has asserted that Taxpayer's gain on a non-identified hedging transaction is ordinary gain because Taxpayer did not have reasonable grounds for failing to properly identify the transaction as a hedging transaction. Taxpayer concedes the transaction qualified as a hedge for tax and financial accounting purposes and was identified as such for financial accounting purposes.

Taxpayer claims that its failure to identify its hedges under the section 1221 regulations was an "inadvertent error" within the meaning of section 1.1221-2(g)(2)(ii) and further claims that this supports two separate arguments against the Service's application of the section 1.1221-2(g)(2)(iii) anti-abuse rule. First, Taxpayer asserts that by satisfying the inadvertent error rule of section 1.1221-2(g)(2)(ii) it is insulated as a matter of law from having its gain treated as ordinary under the section 1.1221-2(g)(2)(iii) anti-abuse rule. Taxpayer claims that this is supported by the language of the inadvertent error regulation that states that a taxpayer "may" treat gain or loss as ordinary income. Second, Taxpayer alternatively argues that "inadvertent error" is, as a factual matter, "reasonable grounds" for treating the transaction as other than a hedging transaction.

Taxpayer's argument that inadvertent error gives it per se immunity from challenge under section 1.1221-2(g)(2)(iii) attempts to extend the section 1.1221-2(g)(2)(ii) inadvertent error rule beyond its stated purpose. Both sections 1.1221-2(g)(2)(ii) and (iii) are described as exceptions to the general rule of section 1.1221-2(g)(2)(i) -- that the absence of an identification that satisfies the requirements of section 1.1221-2(f) is binding and establishes that the transaction is not a hedging transaction. Neither section 1.1221-2(g)(2)(ii) nor (iii) suggest that the inadvertent error rule overrides or is an exception to the Service's authority to challenge whether a taxpayer had "reasonable grounds" for failing to identify a transaction as a hedging transaction. The two provisions operate independently and satisfy different purposes, convey differing rights to differing parties and contain differing standards for their application.

There are sound policy reasons for the Service having an independent right to challenge abusive failures to identify. In fact, the potential ability of a taxpayer with the

benefit of hindsight to claim inadvertence and to choose the character of gain or loss on a hedge makes all the more important the Service's ability to deny capital gain treatment unless reasonable grounds for non-identification exists. Without the Service ability to independently challenge the treatment of hedge gain as capital, the section 1.1221-2(g)(2)(ii) exception for inadvertence would potentially afford taxpayers substantial selectivity with hindsight, i.e., taxpayers could ignore the hedging identification requirements knowing that with hindsight that inadvertence could be claimed so that losses could be treated as ordinary and gains could be treated as capital.

Taxpayer also seems to rely heavily on TAM 200510028. As you have already observed, that technical advice memorandum does not even address section 1.1221-2(g)(2)(iii) or a relevant fact pattern. Moreover, there is nothing startling about the statement in the technical advice memorandum that a taxpayer may but is not required to treat gain or loss as ordinary even if its failure to identify was due to inadvertent error. The statement adds little or nothing to what is already reflected in the language of section 1.1221-2(g)(2)(ii) itself.

The Taxpayer's second argument is that the existence of "inadvertent error" factually establishes that it had "reasonable grounds" for failing to identify the transactions as hedges. Consistent with the analysis above, there is nothing in section 1.1221-2(g)(2)(iii) that suggests that "inadvertence" in failing to make an election is even factually relevant to the substantive question of whether reasonable grounds for the election exist. Instead, section 1.1221-2(g)(2)(iii) states that reasonableness is measured "by taking into consideration not only the requirements of (b) [the hedge definitional requirement] of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions." Thus, reasonableness is assessed by looking at whether there was reasonable legal grounds (based on the definition of a hedge) for failing to identify, taking into account two other factors – the taxpayer's non-tax treatment of the item and the taxpayer's tax treatment of similar transactions. Those two factors are sensibly considered relevant because they bear on whether there existed reasonable grounds for failing to identify. The existence of inadvertence in making or not making an election, however, sheds little or no light on whether reasonable substantive grounds existed for failing to identify. In this case, Taxpayer concedes the transactions were hedges for tax purposes and its financial accounting for such bolsters that conclusion. Accordingly, we see little if any basis for Taxpayer's contention that it had reasonable grounds within the meaning of section 1.1221-2(g)(2)(iii) for failing to identify the hedges for federal income tax purposes.

Much of the discussion above assumes that Taxpayer's failure to identify was inadvertent. We do not wish to substitute our judgment for yours on the issue of whether the taxpayer's failure was inadvertent. Nevertheless, Taxpayer's claim that it did not have hedging procedures in place for addressing "similar" transactions warrants comment. While Taxpayer is correct in its assumption that prior practice and procedures are relevant, it is not enough for a taxpayer to simply claim that it had not

identified “similar” transactions as hedges. Rather, Taxpayer’s practice with regard to all prior hedging transactions, including foreign currency, would be relevant. Moreover, Taxpayer cannot reasonably claim to have established inadvertence simply because the government does not have facts or documents showing that Taxpayer knowingly chose not to identify the transaction. Obviously, documentation of that nature would rarely be found. Instead, Taxpayer should bear the burden of proving inadvertence, and its satisfaction should be judged on all surrounding facts and objective indicia of whether the claimed oversight was truly accidental. The size of the transaction, the treatment of the transaction as a hedge for financial accounting purposes, the sophistication of the taxpayer, its advisors, and counterparties, among other things, are all probative. We particularly noticed that Taxpayer had internal procedures requiring high level approval of hedges and that those procedures required consideration of the tax consequences of the hedging transactions. Close attention was apparently given to financial accounting aspects of its hedging, yet complete unawareness of tax hedging issues is claimed. Evidence that tax personnel were consulted with or involved in these transactions would be particularly significant.

We hope that the above is helpful in your ongoing evaluation of this matter.