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From:
Sent: Wednesday, July 14, 2010 1:09:57 PM
To:
Cc:
Subject: Modification of Advice on Claimed Inadvertent Failure to Identify Section 1256 Contracts as Hedges

On April 20, 2010, this office issued you case specific advice that, among other things, stated that Taxpayer did not have a legal basis for claiming ordinary treatment for certain section 1256 contracts that it alleges it inadvertently failed to identify as hedging transactions. That advice pointed out that the section 1.1256(e)-1 regulations do not incorporate the section 1.1221-2(g)(2)(ii) inadvertent error exception, but instead require that identification be timely and clearly made in accordance with section 1.1221-2(f)(1). Taxpayer claims, among other things, that the email advice was incorrect because it failed to take into account section 1256(f)(2), which specifically precludes 60/40 character treatment for gain or loss that would otherwise be ordinary.

Taxpayer is correct. The April 20, 2010 advice failed to adequately consider section 1256(f)(2), but more particularly the limited effect that section 1256(a)(3) has in regard to character. Taxpayer is not precluded, as a legal matter, from arguing that its nonidentified section 1256 contracts were ordinary section 1221(a)(7) hedging transactions that it inadvertently failed to identify. This email serves to modify the prior advice and also more extensively comments on Taxpayer's factual claim of inadvertent error.

Section 1256(a)(1) provides that each section 1256 contract shall be treated as sold for fair market value on the last business day of the taxable year. Section 1256(a)(3) treats the gain or loss from such section 1256 contracts as 40% short-term capital gain or loss and 60% long-term capital gain or loss. Section 1256(f)(2) provides that section 1256(a)(3) shall not apply to any gain or loss which, but for such paragraph, would be ordinary. The language in section 1256(f)(2) has existed since the enactment of section 1256. Consistent with the language of both section 1256(a)(3) and section 1256(f)(2), the Staff of the Joint Committee on Taxation did not consider Congress to be wholly replacing then existing rules, including general hedging rules, for determining character when it enacted section 1256. The Blue Book stated,

> Regulated futures contracts continue to constitute capital assets in all cases in which they would have constituted capital assets under prior law. Treatment of gains and losses as partially short-term and partially long-term is not intended to affect the character of such contracts as capital

> assets nor to eliminate the holding period requirements applicable to assets which are not regulated futures contracts. Any ordinary income or loss items on the mark-to-market system continue to be taxed at the regular tax rates applicable to such income. Thus, for example, gain or loss on a position not identified as a hedging transaction under section 1256(e) that is treated as an ordinary income asset under the rule of the *Corn Products* decision will constitute ordinary income or loss and is not subject to the 60/40 rule.

Staff of the Joint Comm. On Tax'n, 97th Cong., General Explanation of the Economic Recovery Tax Act of 1981, at 297. It is evident from both the statutory language and the limited legislative history that Congress was not intending to alter the baseline character treatment of contracts that would otherwise be given ordinary treatment under other authority. See also section 1256(f)(3)(B).

Based on the above, Taxpayer is not precluded, as a legal matter, from establishing that gains and losses on its section 1256 contracts were ordinary under section 1221(a)(7). We apologize for any inconvenience created by the prior advice.

Taxpayer's recent response also included a number of factual clarifications, mostly pertaining to its claim that its nonidentification of section 1256 and other contracts as hedging transactions was due to section 1.1221-2(g)(2)(ii) inadvertent error. At least at this time, we find little in Taxpayer's response that justifies revising our prior advice that Taxpayer has not demonstrated that its failure to identify was inadvertent error. However, given you are far closer to the facts, you are ultimately in the best position to judge whether Taxpayer can satisfy its factual burden. Nevertheless, in light of the increased pressure on the factual issue, we are passing along a few additional observations regarding the general direction of Taxpayer's factual argument.

Taxpayer continues to have the burden of demonstrating that its failure to identify its exchange-traded and other contracts was both "inadvertent" and "error." From what we gather from its latest response, Taxpayer seems to wish to limit the factual focus to its treatment of only certain contracts. We do not consider that appropriate. Instead, you should consider all relevant facts and circumstances; thus, you should be taking into account Taxpayer's treatment for book and tax purposes of all transactions which were economic hedges or which it has previously claimed were hedging transactions, whether pertaining to its inventory or interest rate risks or whether entered into before or after the refund claim period. Taxpayer's failure to promptly address nonidentified hedging transactions or to establish tax hedge identification procedures for any transactions that it has previously asserted to be section 1221 hedges or that were also economic hedges that would qualify as tax hedges substantially undercuts Taxpayer's inadvertent error claim.

Although we are not willing to say that any particular factor will prove conclusive, we see a number of considerations that do not suggest inadvertent error. Among other things, we do not see where Taxpayer has demonstrated that it: (a) specifically intended to identify the exchange-traded contracts or other contracts as tax hedges; (b) reasonably undertook efforts to apprize itself of tax hedging rules and requirements; or (c) made reasonable and prompt efforts to correct past nonidentifications or timely identify prospective hedges even after it asserts first being aware of the tax hedging rules. Apart from these considerations, Taxpayer statements or other evidence indicating that it anticipated having ample capital gains to absorb capital losses would suggest a deliberate decision (albeit perhaps a poor one) not to address its lack of tax hedge identification procedures.

Taxpayer's argument seems almost exclusively dependent on its claim of ignorance of the rules and upon its claim that the section 1256 and other contracts otherwise satisfied the definition of a hedging transaction under section 1221(b)(2)(A). In our view, the inadvertent error rule is not intended to eviscerate the section 1221(a)(7) identification requirement, which is a requirement for both subchapter C corporations and non-subchapter C corporations. Subchapter C corporations would normally find it advantageous to identify their otherwise qualifying tax hedges unless perhaps they hope to avoid or game the hedge timing rules or hope to generate capital gains that can absorb capital losses. Consequently, depending on how liberally the regulatory enabling language in section 1221(b)(2)(B) is read, Treasury and the Service might have been able to write regulations that presumed identification of some or all section 1221(b)(2)(A) hedging transactions, perhaps subject to being identified out of section 1221(a)(7) treatment. That was not done. Instead, the system in place requires all taxpayers to unambiguously identify their hedges with relief afforded for inadvertent errors. Absent a change in the regulation, we see no compelling policy justification for reading the inadvertent error rule as an open-ended invitation for taxpayers to brush aside establishing hedge identification procedures, knowing that inattention to the rules or even unsound judgment (as seems to be the case here) can be fixed on an as needed basis. A system that operated as loosely as Taxpayer perhaps envisions would substantially undermine the section 1.1221-2(f)(2) requirement that taxpayers timely identify items hedged and the section 1.446-4 recordkeeping requirements.

Except where specifically provided, this email is not intended to modify the April 20, 2010 email advice. Thus, among other things, this email should not be read to suggest that the Service views ignorance of the tax rules as sufficient to establish inadvertent error under section 1.1221-2(g)(2)(ii). Further, the above analysis does not alter prior advice that a taxpayer must timely and clearly identify its hedges under section 1256(e) in order to avoid section 1256(a)(1) mark-to-market treatment, regardless of whether the section 1.1221-2(g)(2)(ii) inadvertent error rule can be satisfied.

Please feel free to call if you would like to discuss any of the above.