

New US Tax Hedging Guidance Provides Planning Opportunities

By Mark Leeds¹

"Prediction is difficult – particularly when it involves the future."² Unfortunately for most businesses, however, being able to predict future prices of components (physical or financial) to be incorporated into their products or services is often particularly important in order for them to be able to accurately price such goods and services. An inability to predict input prices is not fatal, however, because businesses can use a variety of financial products to hedge component prices. For those of us advising businesses that use the financial and commodity markets to hedge price risk, certain tax considerations applicable to hedging transactions can be murky.

The US Internal Revenue Service (the "IRS") first promulgated regulations in 1994 addressing the character and timing of income and loss recognition in hedging transactions.³ In 1999, Congress, through the enactment of Section 1221(a)(7) of the Internal Revenue Code of 1986, as amended (the "Code"), codified the IRS position on character and expanded taxpayers' ability to treat transactions as hedging transactions.⁴ The rules for futures contracts and other financial instruments subject to Code § 1256 have long contained provisions that exempt such contracts from statutory mark-to-market rules (timing) and 60/40 capital gain treatment (character).⁵ But one key issue—the source of income and loss from hedging transactions—has not been the subject of any congressional rules, IRS guidance or court decision until now. And the new guidance should provide taxpayers with additional flexibility to structure hedging transactions in a manner that mitigates the US tax burden associated with such transactions.

Why does the source of hedging gains and losses matter?

Source can be determinative of whether the hedging gains and losses are subject to US federal income tax. If a taxpayer group consists of both US and non-US corporations and only the US corporations are subject to United States federal income tax, then to the extent that hedging gains and losses are attributed to the non-US companies, such gains and losses would not be subject to US tax. In addition, hedging gains and losses treated as foreign-source gains and losses could have an effect on the amount of foreign tax credits available to the company engaged in the hedging transactions.

The Facts and Holding of PLR 202140016

In PLR 202140016 (October 8, 2021), the Taxpayer, directly and through numerous US and non-US subsidiaries, was engaged in the manufacture and sale of tangible personal property (the "Products") to unrelated third parties. Products were manufactured both within the United States as well as

outside of the United States. It also purchased Products from third parties and resold these Products to unrelated third parties.

The Taxpayer regularly traded “commodity derivatives, including futures contracts and options contracts (the “Commodity Derivatives”) . . . to ensure operational predictability by managing price risk associated within its inventory property.” The trading of Commodity Derivatives was undertaken by two US subsidiaries of the Taxpayer: Affiliate 1 and Affiliate 2. Affiliate 1 executed all transactions from within the United States. Affiliate 2, however, traded from within and outside of the United States . Both Affiliate 1 and 2 only hedged risks faced by US companies owned by the Taxpayer.

The Taxpayer employed a very sophisticated hedge identification system. The system recorded the related physical trade, trade item, commodity type, deal type, dates and pricing information, which included the currency and the calendar month in which the derivative expires. The system satisfied the requirements for the transactions in Commodity Derivatives to be properly identified as hedges for federal income tax purposes.⁶

The Taxpayer reported the source of the hedging gains and losses by reference to the source of income from the sale of the hedged inventory. It asserted that determining the source of its hedging gains and losses under the rules for determining the source of the Commodity Derivatives would result in such gains and losses being mismatched from the items being hedged.⁷ Specifically, without a hedging overlay, the gains and losses from the Commodity Derivatives would always have been US-source income because the companies undertaking the transactions were US persons.⁸

The IRS cited two cases holding that, in the absence of a rule directly on point, the source of income for federal income tax purposes should be determined by analogy to the closest rule on point. Since the transactions in Commodity Derivatives were directly related to managing risk on the inventory sales, the gains and losses from these transactions were held to be properly sourced to the place that the inventory sales occurred. The Taxpayer was permitted to ignore the source rules that would have applied if the transactions in Commodity Derivatives were considered as standalone transactions.

Takeaways from the PLR

Most companies that use the futures markets for hedging transactions have tax hedging policies in place. These policies often obviate the need to specifically identify hedging transactions. Very few (if any) hedging policies, however, contain rules for specifying how the source of hedging transactions will be determined. PLR 202140016 creates an opportunity to revisit hedging policies to provide source rules for hedging transactions. In implementing any such change, however, taxpayers must be sure the rules requiring IRS consent for changes in accounting methods are not implicated. If such rules are implicated, the path to changing how source of income is determined in connection with hedging transactions may require seeking IRS consent for such a change.⁹

Endnotes

- ¹ Mark Leeds (mleeds@mayerbrown.com; (212) 506-2499) is a tax partner with the New York office of Mayer Brown. Mark's legal practice focuses on the US tax issues associated with financial products, financial institutions and capital market transactions.
- ² Attributed to both Mark Twain and Niels Bohr.
- ³ See Treasury Regulation § 1.446-4 (adopted by TD 8554 in 1994). This regulation was amended twice in 1996 TD 8653 and TD 8674) and once in 2002 (TD 8985).
- ⁴ PL 106-170 (the Tax Relief Extension Act of 1999).
- ⁵ Code § 1256(e)(1); *see also* Code § 1256(f)(1) (capital gain treatment denied for any transaction that "at any time" had been designated as a hedging transaction).
- ⁶ *See* Treas. Reg. § 1.1221-2(f).
- ⁷ Under Code §§ 861(a)(6) and 865(b), the source of gain and loss from purchased inventory is based on where the sale of the inventory occurs. Under Code § 863(b), the source of gain and loss from manufactured inventory is based on the location of the production activities. The general source rule for personal property sales is based on the residence of the taxpayer. Code § 865(a). The general source rule does not apply to derivatives. Treas. Reg. § 1.865-1(c)(1).
- ⁸ Code § 865(a); but *see* Code § 865(e) (sales by residents through an office located outside of the United States is treated as foreign-source income).
- ⁹ *See* Code § 446(e).

Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world's leading companies and financial institutions on their most complex deals and disputes. With extensive reach across four continents, we are the only integrated law firm in the world with approximately 200 lawyers in each of the world's three largest financial centers—New York, London and Hong Kong—the backbone of the global economy. We have deep experience in high-stakes litigation and complex transactions across industry sectors, including our signature strength, the global financial services industry. Our diverse teams of lawyers are recognized by our clients as strategic partners with deep commercial instincts and a commitment to creatively anticipating their needs and delivering excellence in everything we do. Our "one-firm" culture—seamless and integrated across all practices and regions—ensures that our clients receive the best of our knowledge and experience.

Please visit mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

Any tax advice expressed above by Mayer Brown LLP was not intended or written to be used, and cannot be used, by any taxpayer to avoid U.S. federal tax penalties. If such advice was written or used to support the promotion or marketing of the matter addressed above, then each offeree should seek advice from an independent tax advisor.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek legal advice before taking any action with respect to the matters discussed herein.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the "Mayer Brown Practices") and non-legal service providers, which provide consultancy services (the "Mayer Brown Consultancies"). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website.

"Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2021 Mayer Brown. All rights reserved.