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# Energy Derivatives Through Federal and State Tax Glasses

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Andrea Kramer, John Biek and David Lee address the U.S. federal and state tax treatment of energy derivatives and transactions used for price risk management and income generation.

Energy companies have been active in the energy derivatives markets for more than a decade. Although energy trading activities slowed down after the Enron bankruptcy, those activities have once again picked up. As a result, federal and state tax issues need to be considered. In this article, we address the U.S. federal and state tax treatment of energy derivatives and transactions used for price risk management and income generation. First, we provide a brief overview of popular energy trading products, addressing forward contracts, futures contracts, options, swaps and tolling agreements. Next, we set out relevant federal tax considerations, addressing the straddle rules, Code Sec. 1256 contracts, special rules for certain derivative products, elective mark-to-market provisions, commodity derivative dealer transactions and the tax hedging rules. We then set out relevant state tax considerations, starting with the relevant federal constitutional and statutory issues and then addressing relevant state tax concepts. And finally, we conclude with a few observations.



## Popular Products

### Forward Contracts

Forward contracts are privately negotiated over-the-counter (OTC) bilateral agreements between two parties for the purchase (sale) of a commodity for delivery at an agreed-upon date in the future, typically at a fixed or market price. Some of these products are traded on an exchange (exchange-traded products) or are entered into as bilateral contracts between two parties, referred to as the "over-the-counter" or "OTC" market. Forward contracts are not freely transferable, and the parties usually intend to make (or take) delivery of the underlying commodity, with payment made "in full" at delivery. Thus, each party to a forward contract assumes the risk that the other party will not perform its obligations.

With the consent of both parties, a forward contract can be cancelled prior to delivery, with the "out-of-the-money" party making a payment to the "in-the-money" party. For forward contracts on electricity (power), physical delivery is not often required. Most power forward contracts are settled by "book-outs," with the parties settling their obligations with a cash payment equal to the difference between the contract price and the relevant reference market price. The parties to a book-out agree to the price at which they enter into an offsetting transaction, with the difference between the book-out price and the forward contract price settled in cash. They do not make or take delivery of the power.

Energy forward contracts are increasingly traded on electronic trading platforms, such as the InterContinental Exchange (ICE), an online marketplace for electricity, natural gas, crude oil, refined petroleum products, precious metals, weather and emission credits. By way of example, in 2005, over 62 million contracts were traded on ICE's OTC market with an aggregate notional value of $1.6 trillion (and 47.4 million contracts were cleared by ICE).[1] Electronic

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platforms continue to grow, as financial service and technology companies enter into OTC electronic trading and services markets.

Wholesale power market participants "exchange" or "swap" physical power, exchanging power in different locations, available at different times, or exchanging on-peak for off-peak power. These "swaps" involve physical deliveries between the parties and (for tax purposes) are technically forward contracts, not swaps.

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## Futures Contracts

Futures contracts are standardized, exchange-traded contracts to purchase (or sell) for a fixed price a specified quantity and grade of a commodity for delivery at a specified time and place in the future. One party agrees to sell (on the floor of a registered commodity exchange or through an electronic market sponsored by a commodity exchange) a commodity (short position) on a specified future date, and the other party agrees to accept delivery of and pay for the commodity on the specified future date (long position). When entering into a futures contract on a U.S. exchange, neither party pays any consideration to the other party. Instead, to assure payment, U.S. futures contracts are subject to a margining system that serves as a good faith deposit, not as a payment of the purchase price.

Open futures contracts are closed by delivery of the underlying commodity; cash settlement at maturity of the contract; or by entering into an offsetting futures position before maturity (closing transaction). In a closing transaction, the party pays (or receives) the difference between the price paid for the long contract and the price received for the short contract.

Futures market participants are often active in the futures market to fix the future sale price of inventory or the cost of future supply needs. At present, electricity futures contracts trade on NYMEX (New York Mercantile Exchange), SFE (Sydney Futures Exchange), ASX (Australian Stock Exchange),[2] APX (Amsterdam Power Exchange), EEX (European Energy Exchange), the Nordic Power Exchange, ICE Futures (a subsidiary of ICE, the on-line electronic trading platform) and (in the near future) the CME (Chicago Mercantile Exchange).[3]

## Options

From the perspective of the buyer (the "holder" or "long" position), an option grants the holder the right, but not the obligation, to buy (or sell) the specified amount of the underlying commodity at a fixed or determinable price on a specified date or for a specified time period. From the perspective of the seller (the "writer" or "short" position), an option obligates the writer to perform (to sell or to buy), if—but only if—the holder exercises the option. A call option gives the holder the right to buy (and obligates the writer to sell) the underlying commodity at the agreed to strike price. A put option gives the holder the right to sell (and obligates the writer to buy) the underlying property at the agreed to strike price.

Market participants enter into both exchange-traded and OTC options on energy products. They also enter into options that settle in cash (also called "financial options"), with values determined by reference to specified commodities and prices. Purchasing "capacity in the power market" is viewed as purchasing an option because it gives the purchaser the right (but not the obligation) to schedule delivery of power.

## Swaps

A swap is an OTC agreement between two parties (referred to as "counterparties") to exchange payments at specified dates (periodic payment dates) on the basis of a specified amount (notional amount), with the payments calculated on different assets, indices, or rates. When the periodic payment dates are the same for both parties, payments are netted with only the net amount paid to the party entitled to receive the net payment. Swaps are entered into on energy commodities, weather conditions, emissions and a wide range of indices.

## Tolling Agreements

Tolling agreements provide "synthetic" generation capacity, where one party ("Facility Owner") agrees—subject to the contract terms—to use its power generation facility to generate power from natural gas, coal, or another designated fuel provided by the other party ("Tolling Owner"). Under a typical tolling agreement, Facility Owner does not

sell natural gas or power to Tolling Owner. Instead, Facility Owner simply agrees to use its generation equipment to generate power by converting the fuel supplied by Tolling Owner into power owned by Tolling Owner. Facility Owner provides its facility, while Tolling Owner makes all decisions with respect to the sale of its power.

Under a typical tolling agreement, Tolling Owner pays Facility Owner for variable operating costs associated with generating the power at the time (or times) specified. Tolling Owner also pays periodic "tolling capacity payments" to Facility Owner for standing ready to provide generation capacity at its facility. Tolling capacity payments compensate Facility Owner for relinquishing its rights to control its generation capacity at its facility. In general, tolling capacity payments are made without regard to whether (or to what extent) Tolling Owner actually uses the facility.

To evaluate federal tax consequences properly, it is important to understand the transaction and whether the taxpayer is a dealer, hedger or trader.

## Federal Tax Rules



Federal tax rules for derivatives generally aim at stopping taxpayer abuses, with different rules applying to different products and with election and identification requirements to obtain the most advantageous—or the least onerous—tax results. Tax analysis is made even more difficult because tax consequences often turn on economically irrelevant factors, including the following:

- Is the product traded on a domestic exchange, foreign exchange or in the OTC market?
- Is the product a futures contract, forward contract, option or a so-called notional principal contract?
- Has a tax election been made?
- Has a tax identification been made?
- Does the transaction involves a commodity or a foreign currency?

In other words, economic similarity between different types of derivatives is often irrelevant in determining tax character and timing.

To evaluate federal tax consequences properly, it is important to understand the transaction and whether the taxpayer is a dealer, hedger or trader. In addition, three principal tax considerations—character, timing and source—need to be evaluated. Tax character is often based on the taxpayer's status as a dealer, hedger or trader, although it is sometimes determined by the product involved. With respect to tax timing, gains and losses from derivative transactions are separately recognized, even if the transaction is part of a hedge or risk management strategy.[4]

The type of asset is important in determining tax character. Sale (or exchange) of a capital asset results in capital gains or losses, while a sale (or exchange) of an ordinary asset generates ordinary income or loss. Capital gain or loss only results if there is a sale (or exchange) of the asset. For corporations, capital gain is taxed at the same rate as ordinary income, although capital loss (which can only be used to offset capital gains) can be carried back three years and carried forward five years.

Capital assets are defined in the Internal Revenue Code ("the Code") by negative inference. Code Sec. 1221 defines a "capital asset" as property (whether or not connected with a trade or business) that is not of the types specifically listed in Code Sec. 1221(a). Unless an asset falls within one of these enumerated categories, it is viewed as a capital asset. Ordinary property is defined in Code Sec. 1221(a) as (1) stock in trade of the taxpayer or other property of a kind that would properly be included in inventory[5]; (2) real property or other depreciable property used in the taxpayer's trade or business[6]; (3) copyrights, literary, musical or artistic compositions, a letter or memorandum or similar property[7]; (4) accounts or notes receivable acquired in the ordinary course of the taxpayer's trade or business for services rendered or from the sale of inventory[8]; (5) publications of the US government[9]; (6) any commodities derivative financial instrument held by a commodities derivatives dealer[10]; (7) hedging transactions that are clearly and timely identified[11]; and (8) supplies.[12]

### Tax Straddles

Special tax rules apply to tax straddles,[13] consisting of "offsetting positions with respect to personal property."[14] A taxpayer holds a straddle if it holds two or more positions in personal property if holding one position substantially reduces the taxpayer's risk of loss from holding the other position. Personal property

is defined as any personal property that is actively traded.[15] The Code provides no guidance as to when property is actively traded, with the relevant legislative history providing only minimal guidance, stating that "[i]n order to be treated as actively traded, property need not be traded on an exchange or in a recognized market."[16] As a result, the definition of personal property—for application of the straddle rules—is broader than the types of property traded on an exchange or in a recognized market. It includes property not generally thought of as actively traded and includes "interests" in personal property (such as futures, forwards and options) if those interests are actively traded.[17]

## Section 1256 Contracts

"Section 1256 contracts" (defined in Code Sec. 1256(g)) are subject to two special tax rules. The first rule "marks" section 1256 contracts "to market," which means that unrealized gains and losses are reported at year-end on open (not just closed) section 1256 contract positions marked at their fair market values on the last business day of the tax year ("Mark-to-Market Rule"). The second rule treats gains and losses as 60-percent long-term and 40-percent short-term capital gains or losses ("60/40 Rule"), unless the contracts are ordinary assets or the hedging exception applies.[18] Section 1256 contracts include (1) regulated futures contracts (RFCs); (2) foreign currency contracts; (3) nonequity options; (4) dealer equity options; and (5) dealer securities futures contracts.[19] The two types of section 1256 contracts most likely to be entered into by an energy trading company are RFCs and nonequity options, both of which are discussed in the remainder of this section.

RFCs are futures contracts where the amount required to be deposited and the amount that can be withdrawn on open positions depends on a system of marking to market and that are traded on (or subject to) the rules of a qualified board or exchange.[20] A qualified board or exchange is defined as (1) a national securities exchange registered with the Securities and Exchange Commission (SEC); (2) a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission (CFTC); or (3) any other exchange, board of trade or market that the Treasury Secretary determines has rules adequate to qualify as a qualified board or exchange.[21] Accordingly, U.S. traded futures contracts are RFCs and, therefore, are section 1256 contracts.

A nonequity option is any "listed option" that is not an "equity option."[22] A listed option is any option that is traded on (or subject to the rules of) a qualified board or exchange.[23] An equity option is any option (1) to buy or sell stock, or (2) the value of which is determined directly or indirectly by reference to any stock or narrow based security index.[24] Energy options traded on (or subject to the rules of) a qualified board or exchange are nonequity options and, therefore, are section 1256 contracts.

## Options

Premiums paid or received to enter into options are not currently deducted or reported as income. Rather, premiums are treated as capital expenditures carried in a deferred account as an "open transaction" until the position is closed. Once an option is exercised, its tax character depends on the type of asset the underlying property is in the hands of the taxpayer. If an option is sold, disposed of, or expires, gain or loss has the same tax character as the property to which the option relates has in the hands of the taxpayer.[25]

## Forward Contracts

For forward contracts settled by physical delivery, the seller's gain or loss is based on its tax basis in the underlying commodity, while the buyer does not recognize any gain or loss at that time. Rather, the buyer realizes a gain or loss on subsequent disposition of the underlying commodity, with tax basis equal to the price paid for the commodity under the forward contract.

Most forward contracts do not allow for cash settlement, although the parties can agree (between themselves) to cash settle their contracts. Code provisions do not deal directly with cash-settling forward contracts but Code Sec. 1234A provides that gain or loss on the cancellation, lapse, expiration or other termination of a right (or obligation) with respect to a capital asset is treated as gain or loss from the sale of a capital asset. In a book-out, the parties agree to the price at which they will enter into an offsetting transaction. To the extent the purchase and sale obligations match, the obligations are offset. Open transactions are thus netted, with the difference between the book-out price and the forward contract price settled in cash. Under Code Sec. 1234A, tax character from a book-out (discussed above) depends on the tax character of the forward contract in the taxpayer's hands. Book-outs generally result in ordinary income or loss for dealers and hedgers (and capital gain or loss for investors and traders).

## Notional Principal Contracts

The tax term "notional principal contract" (NPC) applies to certain OTC bilateral contracts where the principal amount is a calculation based on an amount that is specified in the contract but is not actually transferred between the parties. The parties do not exchange, invest or borrow the notional amount, as it is just a "notion" or an "idea."

An NPC "provides for the payment of amounts by one party to another (at specified intervals) calculated by reference to a specified index upon a notional principal amount in exchange for a specified consideration, or a promise to pay similar amounts."[26] Neither party is required to deliver property, and at least one party has an obligation to make more than one payment to the other party if the contract's conditions are met.

NPCs can have three different types of payments: (1) periodic payments; (2) nonperiodic payments; and (3) termination payments, each of which is discussed in the remainder of this section.

### *Periodic Payments*

Periodic payments are made or received at intervals of one year or less during the entire term of the contract (including extension periods provided for in the contract). They are based on a specified index multiplied by either (1) a single notional principal amount, or (2) a notional amount that varies over the term of the NPC in the same proportion as the notional principal amount that measures the other party's payments. Periodic payments due on the same payment date are usually netted. All taxpayers, regardless of their tax accounting method, recognize the ratable daily portion of periodic payments in the tax year to which that portion relates.[27] And, because taxpayers offset periodic payments with receipts from the same contract, taxpayers only report (as ordinary income or loss) net income or deductions for the year.

### *Nonperiodic Payments*

Nonperiodic payments are defined as payments "other than" periodic or termination payments. To the extent payments are not based on a fixed, periodic interval of one year or less, they are nonperiodic payments if they are not defined as termination payments (discussed below). Nonperiodic payments include (1) premium payments for a cap or floor (even if paid in installments); (2) payments to enter into off-market swaps; (3) prepayments of part (or all) of one side of an NPC; and (4) premiums for options to enter into NPCs.[28] All taxpayers, regardless of their tax accounting methods, recognize the ratable daily portion of nonperiodic payments in the tax year to which that portion relates[29] Accounting for nonperiodic payments reflects the economic substance of the contract,[30] denying an immediate deduction for upfront payments while providing the recipient with tax deferral. Nonperiodic payments can be either ordinary or capital, depending on whether the nonperiodic payment results in a cancellation, lapse, expiration or other termination of a capital asset.

### *Termination Payments*

Termination payments are made or received to extinguish (or assign) rights and obligations of any NPC party,[31] including (1) payments between the original parties to the contract (extinguishment); (2) payments between one party to the contract and a third party (assignment); and (3) any gain or loss on the exchange of one NPC for another NPC. Termination payments and any unamortized portions of any nonperiodic payments are recognized in the year in which the contract is disposed of.[32] Termination payments generate ordinary income for dealers and hedgers and capital gain or loss for investors and traders. As a result, the amount one party pays to terminate an NPC could be capital, rather than ordinary, loss.

## Section 475 Mark-to-Market Election

To avoid character and timing mismatches, eligible taxpayers can elect to make commodity dealer or trader elections under Code Sec. 475(e) and (f). Making such elections preclude the possibility of a tax whipsaw if a taxpayer improperly relied upon—or failed to comply with—the tax hedging rules discussed below. Once elected, the taxpayer marks all physical and financial commodity transactions to market for tax purposes. For Code Sec. 475 purposes, commodity is defined broadly to include any commodity that is actively traded,[33] including physical and derivative commodities (such as NPCs, options, forward contracts, futures contracts, short positions and similar instruments). A commodity is also defined to include any position that is not itself a commodity if the position serves as a hedge of a commodity and is identified on the day it is entered into.[34]

Commodity dealer and trader elections are made on a taxpayer-by-taxpayer basis. As a result, if one consolidated group member makes a mark-to-market election, other group members need not adopt mark-to-market tax accounting. Transactions between

group members where one member is on mark-to-market for tax purposes must be accounted for by both parties on a mark-to-market basis.[35]

A commodities dealer can elect into Code Sec. 475(e) for all of its physical and derivative commodities, subjecting it to the same rules that apply to dealers in securities. Commodities held by the taxpayer in its capacity as a dealer give rise to ordinary income or loss on the mark, while commodities not held in the taxpayer's capacity as a dealer can be removed from marked-to-market (and ordinary treatment) if the transactions are properly and timely identified as meeting one of the exceptions in Code Sec. 475(b).[36] Commodities not held by a taxpayer in its capacity as a dealer do not receive ordinary income or loss *solely* because the taxpayer made the commodity dealer election.

A commodities trader can elect into Code Sec. 475(f) for commodities held in connection with its trade or business as a trader, generating ordinary income and loss. Transactions can be exempt from Code Sec. 475 if the electing trader can demonstrate that the transactions have "no connection" with its trading activities and the transactions are properly and timely identified as exempt.[37]

An electing commodity dealer or trader "marks" its commodity (both physical and financial) transactions to market for tax purposes, recognizing any unrecognized gain or loss on those transactions that remain open at year-end. To the extent a taxpayer enters into long-term physical or derivative transactions, mark-to-market tax accounting accelerates gains or losses that may not actually be realized in the future.



## Commodities Derivative Dealers

Commodities derivative financial instruments (CDFIs) held by commodities derivatives dealers (CDDs) are ordinary assets and eligible to be part of tax hedges.[38] CDDs regularly enter into, assume, offset, assign or otherwise terminate CDFIs with customers in the ordinary course of their trade or business.[39] CDFIs held by CDDs are ordinary property, without regard to whether they were entered into by the CDDs in their dealer capacity. The only exception to ordinary treatment is for those CDFIs that meet two requirements. First, the taxpayer must show that the contract has "no connection with" its dealer activities. Second, the taxpayer must identify the transaction as exempt before the close of the day on which the transaction was acquired, originated or entered into.[40]

CDFIs include contracts where the value (or settlement price) is calculated by (or determined by reference to) a specified commodity index. CDFIs include swaps, caps, collars, floors, options, forward contracts and similar contracts or instruments. CDFIs, on the other hand, do not include section 1256 contracts[41] held by CDDs.[42] Instead, section 1256 contracts generate capital gain or loss, unless otherwise treated as ordinary under another Code provision (such as the tax hedging rules of Code Sec. 1221(a)(7)). Dealer activities of one consolidated group member are not attributed to other group members. In addition, the Treasury is authorized to issue regulations appropriate to carry out the CDD exemption to related party transactions.[43]

## Hedging Transactions

Hedging transactions are entered into in the *normal course* of a taxpayer's trade or business and must (1) meet a "risk management" requirement and (2) be properly and timely identified.[44] "Normal course of business" is broadly defined to include the expansion of an existing business or the acquisition of a new trade or business.[45] In addition, an anticipated risk associated with a business line not currently conducted by the taxpayer can also qualify as a hedging transaction.

### *Risk Management*

A "hedging transaction" must be entered into *primarily* to (1) manage the risk of price changes or currency fluctuations with respect to ordinary property held (or to be held) by the taxpayer, or (2) manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made (or to be made), or ordinary obligations incurred (or to be incurred), by the taxpayer.[46] The hedging regulations permit "anticipatory hedging" of ordinary assets held *or to be held* by the taxpayer, as well as obligations or borrowings incurred *or to be incurred* by the taxpayer.[47] To determine whether a transaction manages risk, the facts and circumstances of the transaction must be considered.[48] A taxpayer's practices and procedures—as reflected in its business records—are evidence of whether a hedging transaction manages risk.[49]

Whether a transaction manages the taxpayer's risk is determined after considering the taxpayer's overall risk profile, so that the taxpayer's "enterprise risk" is managed by the transaction. A hedging transaction that relates to a particular asset or liability manages overall risk if it is undertaken as part of a program reasonably expected to manage the taxpayer's overall risk.[50] In determining whether a transaction manages

risk, the risks that can be considered are those of the taxpayer entering into the transaction. If a taxpayer enters into a transaction to manage the risks of another taxpayer outside of its consolidated group, the transaction is not a "hedging transaction."

If a transaction is part of an aggregate hedging program, the taxpayer need not demonstrate that each transaction is part of its risk management program if the program (as a whole) is reasonably expected to manage the taxpayer's overall risk. Thus, an established aggregate risk management program should prevent the IRS from asserting that a particular hedging transaction does not manage risk even if (when viewed in isolation) the transaction does not manage the taxpayer's risk.

The Treasury regulations set out specific transactions that manage risk.[51] First, a written option may reduce risk.[52] Second, fixed-to-floating hedges that economically convert a price from a fixed to a floating price may reduce risk.[53] Third, a transaction manages risk if it economically converts an interest rate from a fixed (floating) to a floating (fixed) rate.[54] Fourth, a transaction is a valid hedge if it is entered into primarily to offset all (or any part) of the risk management already made by one or more hedging transactions.[55] Fifth, a taxpayer can recycle hedges, meaning that a hedge of one asset or liability can be "recycled" and "tied to" another hedged item or risk, while still qualifying as a tax hedge.[56] Sixth, taxpayers can hedge all (or a part) of their risk for all (or part) of the period during which they are exposed to that risk.[57] And, seventh, trading frequency is irrelevant in determining whether transactions qualify as valid tax hedges.[58]

Treasury regulations issued in 2002 specifically limit risk management transactions to those transactions described in the regulations unless otherwise determined by the government in published guidance or private letter rulings.[59] "Moreover, a speculative transaction is not treated as a hedging transaction."[60] In addition, although no guidance has been issued at the time of this writing, the government also has the authority to issue guidance to determine whether "hedging transactions include transactions entered into to manage risks other than interest rate changes, price changes, or currency fluctuations."[61]

### *Ordinary Property and Obligations*

Hedging transactions manage certain risks on ordinary property, borrowings or ordinary obligations. "Ordinary property" is defined as property that, if sold or exchanged by the taxpayer, could not produce capital gain or loss under any circumstances.[62] This means that inventory items and CDFIs (entered into by CDDs) are ordinary property that can be hedged. Alternatively, Code Sec. 1231 assets cannot be hedged because gain, in some circumstances, can be capital. Similarly, ordinary property does not include assets held for investment. Ordinary obligations are defined to include obligations for which performance or termination could not produce capital gain or loss.[63]

### *Supplies*

Supplies used in the ordinary course of a taxpayer's trade or business generate ordinary income or loss even though supplies are not inventoried for sale and do not become part of the merchandise intended for sale. Hedges of price risks with respect to supplies can qualify as hedges.[64]

### *Transactions Not Covered*

All legitimate hedging activities are not covered by the tax hedging rules because these rules only apply to price, interest rate and exchange risk. Tax hedges must also be tied to ordinary assets, liabilities or borrowings. This means that businesses can be adversely affected by risks that do not qualify as tax hedges. In addition, the purchase or sale of a debt instrument, equity security or annuity contract is not treated as a tax hedge, "even if the transaction limits or reduces the taxpayer's risks with respect to ordinary property, borrowings, or ordinary obligations."[65]

### *Identification Requirements*

A hedging transaction must be clearly identified as a hedge before the close of the day on which it is acquired, originated, or entered into.[66] To meet these requirements, the taxpayer must identify *both* (1) the hedging transaction or "hedge" (the financial transaction intended to reduce current or anticipated risks), and (2) the item, items or aggregate risks being hedged (the "hedged item"). Identification is made on, and retained as part of, the taxpayer's books and records.

Hedge identification is not elective. A taxpayer willing to recognize capital gains or losses cannot avoid the hedging rules by simply failing to identify a transaction. If a transaction is a tax hedge, it must be so identified. Failure to identify an otherwise qualifying transaction properly—as well as incorrectly identifying nonqualifying transactions as tax hedges—allows the IRS to treat gains as ordinary, while treating losses as capital, under the tax character whipsaw rules.[67] This means that taxpayers must identify the assets

or liabilities that create risk as well as the type of risks that the transactions create.[68] The hedge (the risk-reducing transaction) must be identified before the close of the day on which the taxpayer enters into it (the "same-day" identification requirement).[69] The item, items or aggregate risk being hedged (the hedged item) must be identified "substantially contemporaneously," which cannot be more than 35 days after the hedge was entered into.[70]

### *Character Whipsaw*

The IRS can apply two separate character "whipsaws."[71] The first whipsaw applies to transactions that qualify as tax hedges but that the taxpayer fails to identify as a tax hedge properly or timely. The second whipsaw applies to transactions that do not qualify as hedges but that the taxpayer improperly identifies as tax hedges. If either whipsaw rule applies, gains from misidentified transactions are often recharacterized as ordinary, while losses are often recharacterized as capital.

If a hedge is not properly identified (or is improperly identified) as a section 1256(e) hedging transaction, the positions making up a straddle are subject to the straddle rules (discussed above). If a non–section 1256 contract is part of the transaction, gain is ordinary, while loss is ordinary or capital, depending on applicable tax rules. If a section 1256 contract is part of the transaction, the Mark-to-Market Rule applies, resulting in ordinary income on gains. If there is a loss however, it can be either ordinary or 60/40 capital loss. Again, if the positions are part of a straddle, the straddle rules apply.

### *Consolidated Group Hedging*

Transactions entered into by consolidated group members are subject to the "single entity" approach, unless the consolidated group elects for its members to be treated as separate entities. Under the single entity approach, one consolidated group member can hedge the risks of another group member if proper and timely identifications are made.[72] In addition, any consolidated group member can enter into a third-party tax hedge to hedge the risks of another group member, eliminating the need for intercompany hedging transactions *between* consolidated group members. Intercompany hedging transactions do not qualify as tax hedges because they do not reduce the risks of the consolidated group as a whole.[73] Intercompany hedging transactions are not ignored for tax purposes. Instead, gain or loss is accounted for under Reg. §1.1502-13, other rules for intercompany transactions and the mark-to-market rules of Code Sec. 475.

Consolidated groups can opt out of the "single entity" approach by making a "separate entity" election.[74] As a result, all consolidated group members are treated as separate entities instead of divisions of a single entity. Under the separate entity election, a consolidated group member that enters into a third-party hedge to hedge the risk of another consolidated group member is *not* a tax hedge unless the hedging member is acting as the agent of the group member whose risk is being hedged. Intercompany hedging transactions can qualify as tax hedges if the identification requirements are met.[75] Under the separate entity election, hedges are treated as if the character and timing rules of Reg. §1.1502-13 do not apply, and—except for possible application of the whipsaw rules—the marking member's gain or loss is ordinary.[76]

### *Hedge Timing Rules*

The tax timing rules for hedges require the taxpayer to clearly reflect its income,[77] allowing some flexibility in choosing a tax accounting method that fits the way the taxpayer conducts its business (reasonably matching the timing of income, deduction, gain or loss from hedging transactions with the timing of income, deduction, gain or loss from the items being hedged).[78] The tax timing rules apply to all qualifying tax hedges, without regard to whether the taxpayer properly identified the transactions as tax hedges.[79] A taxpayer cannot avoid application of the tax hedge timing rules by failing to properly identify a tax hedge.

### *Hedging Exception to Straddle Rules*

Tax hedges that meet the requirements of Code Sec. 1256(e) (a "section 1256(e) hedging transaction") are exempt from the straddle rules. To the extent a section 1256(e) hedging transaction involves a section 1256 contract,[80] the section 1256 contract is also exempt from the Mark-to-Market Rule under Code Sec. 1256(a).

A section 1256(e) hedging transaction must be clearly identified as a hedge before the close of the day on which it is entered into (or earlier, if required by Treasury regulations). For these purposes, a proper and timely hedge identification under Reg. §1.1221-2 is treated as a proper and timely identification for purposes of Code Sec. 1256(e).[81]

# State Tax Rules

## Introduction

Regulated power and gas utilities have historically had their own specialized set of state tax issues and have operated primarily in a single state, thereby minimizing multistate nexus and apportionment issues. Deregulation has created markets for multistate trading of power and gas. Power and natural gas utilities now sell excess capacity to other utilities and energy trading companies, and they increasingly enter into forward contracts and other agreements to lock-in supplies of power or gas. Some utilities have established special purpose subsidiaries and affiliates to trade energy derivatives. Such energy trading activities create a host of state tax issues that were not of much concern to traditional utilities. As a result, energy trading companies and their tax advisors must understand these state tax issues to address planning opportunities and minimize tax burdens. These issues are discussed in the remainder of this section.

Power and natural gas utilities now sell excess capacity to other utilities and energy trading companies, and they increasingly enter into forward contracts and other agreements to lock-in supplies of power or gas.



## Nexus Issues

"Nexus" is the term used to describe a taxpayer's contact with a state for purposes of determining that state's ability to subject the taxpayer to its tax laws. Companies involved in interstate business must determine whether a particular state has adequate nexus to tax them under the U.S. Constitution (the "Constitution") and applicable state tax statutes.

### *Federal Constitutional and Statutory Limits on State Tax Jurisdiction*

A state's authority to tax out-of-state entities is limited by two Constitutional provisions: (1) the Due Process Clause of the Fourteenth Amendment ("Due Process Clause") and (2) the Commerce Clause under Article I, Section 8, Clause 3 ("Commerce Clause").

## The Due Process Clause

The Due Process Clause addresses the fundamental fairness of governmental activity, with the touchstone of nexus being "notice" and "fair warning." In *Mobil Oil Corp.,*[82] the U.S. Supreme Court set out a two-part test for determining whether a state tax is valid under the Due Process Clause. First, there must be "nexus," or some minimum connection between the taxing state and the activity from which the income or receipts are derived. And second, there must be a rational relationship between the income or receipts attributed to the taxing state and the interstate values of the enterprise. In *Quill Corp.,*[83] the U.S. Supreme Court determined that physical presence is not required under the Due Process Clause, holding that "economic presence" is sufficient to justify taxing out-of-state companies. Under this analysis, the Due Process Clause provides little protection from state taxes for out-of-state companies that conduct a regular and systematic business with customers which are located in the taxing state.

## The Commerce Clause

The Commerce Clause, which addresses undue burdens of state regulation on the national economy, is critical to evaluating nexus. In *Complete Auto Transit, Inc.,*[84] the U.S. Supreme Court formulated a four-prong test to determine whether a state tax is valid under the Commerce Clause. First, substantial nexus must exist between the company and the taxing state. Second, the tax cannot discriminate against interstate commerce. Third, the tax must be fairly apportioned. And fourth, the tax must be fairly related to services provided to the company by the taxing state.

After *Quill,* an out-of-state company must have a physical presence in a state before the company can be subject to that state's sales and use tax. Many state tax administrators contend that *Quill* applies only to sales and use taxes and does not apply to other state taxes—such as income taxes, franchise taxes, gross receipts taxes and business occupation taxes. These administrators apply the "economic presence" analysis advanced by the South Carolina Supreme Court in the *Geoffrey, Inc.*[85] case (discussed below) to such business taxes.

## P.L. 86-272

P.L. 86-272[86] is a federal statute that protects an out-of-state company from state income taxes if the company sells tangible property and limits its activities in that state to the *solicitation of orders* for sales

of tangible personal property, with both acceptance and fulfillment of those orders occurring at locations outside of the taxing state.

Some states treat power as tangible personal property, while others treat it as a service. Those states that treat power as tangible personal property can subject the sale of power to sales taxes, but those states may not be able to tax the income from in-bound sales of power because P.L. 86-272 would apply. For those states that treat power as an intangible or a "service," P.L. 86-272 presumably does not apply because it only applies to persons engaged in selling tangible personal property. In addition, those states that treat options and other derivatives on power as a service presumably would not apply P.L. 86-272 to such trading activities.

Natural gas is treated as tangible personal property, so out-of-state companies should be able to claim protection from state income tax under P.L. 86-272 for physical gas transactions provided delivery takes place out of state. Financially settled gas transactions, on the other hand, can be viewed as investments or services not protected by P.L. 86-272.

> [A] proper understanding of the taxpayer and the types of derivative transactions they enter into is critical in choosing the most optimal federal tax strategy.

### *State Nexus Challenges to Out-of-State Businesses*

Power and gas trading companies should have a physical presence in a state before being subject to state tax, although aggressive state tax administrators may contend otherwise.

One of the first cases to address taxable nexus through economic benefits derived from the taxing state in nonsales and use tax situations was *Geoffrey, Inc.*[87] In *Geoffrey*, the South Carolina Supreme Court upheld South Carolina's tax on royalty income earned by Geoffrey, Inc., a wholly owned Delaware subsidiary of Toys 'R' Us, Inc., that licensed trademarks for use in Toys 'R' Us stores located in South Carolina. The South Carolina Supreme Court declared (in a footnote) that the Commerce Clause did not require Geoffrey to have a "physical presence" in South Carolina to tax Geoffrey's income, finding that *Quill's* physical presence test only applies to sales and use taxes, not to income taxes. The South Carolina Supreme Court held that Geoffrey met the Due Process Clause by its "economic presence" in South Carolina by licensing its intellectual property to stores in South Carolina.[88]

The South Carolina Supreme Court has been criticized for its treatment of the Commerce Clause in *Geoffrey*, and some courts have held that the *Quill* physical presence test applies to income taxes and franchise taxes. In *J.C. Penney National Bank v. Johnson,*[89] for example, the Tennessee Court of Appeals held that Tennessee could not tax the income of an out-of-state credit card affiliate of J.C. Penney unless it showed that the affiliate had a physical presence in Tennessee. Similarly, in *Rylander v. Bandag Licensing Corp.,*[90] the Texas Court of Appeals found that an out-of-state trademark subsidiary that licensed patents to its parent corporation was not subject to the Texas corporate franchise tax on its royalty income under the Commerce Clause. The Texas Court of Appeals found that the out-of-state company had no physical presence in Texas, and its only connection with Texas was in interstate commerce.

In recent years, more state court decisions have followed *Geoffrey,* upholding state corporate income tax assessments on the royalty income of trademark holding companies without a physical presence in the state. These state courts determined that the U.S. Supreme Court in *Quill* intended the physical presence nexus standard of the *Quill* case only to apply to sales and use taxes collected from a vendor's customers, not to other taxes on business profits. These cases primarily addressed whether trademark holding subsidiaries have the necessary Due Process nexus in a state. This issue was not really in dispute, however, because the trademark holding subsidiaries derived royalty income from their parent's use of the licensed intellectual property in retail stores in the state.[91]

It remains to be seen whether the "economic presence" nexus standard of cases like *Geoffrey* will apply to power and gas marketers and other businesses with substantial business operations. In *Steager v. MBNA America Bank, N.A.,*[92] a West Virginia Circuit Court allowed an income tax assessment (under an "economic presence" nexus statute for financial institutions) against an out-of-state credit card bank with economic contacts, but no physical presence,

in the state. The West Virginia Circuit Court refused to apply *Quill's* "bright-line physical presence" nexus standard to income taxes, and concluded that MBNA had "economic presence" in West Virginia as a result of the benefits that MBNA received from West Virginia (such as use of the state's banking and consumer credit laws and access to the state's courts). The West Virginia Supreme Court affirmed the Circuit Court's decision.[93]

Two cases have addressed nexus for energy trading companies in the context of "flash title," with two different conclusions. First, *In the Matter of the Petition of Wascana Energy Marketing (U.S.), Inc.*[94] addressed a Delaware corporation that purchased oil and gas from Canada and sold it to wholesale customers in the United States. The title and risk of loss to gas sold to New York customers was transferred at a delivery point only inches inside of the New York border with Canada. The gas was transported through third-party pipelines to the customers. Wascana personnel negotiated all of the contracts over the telephone or at their offices in either Canada or Houston, Texas. It did not maintain any office or real or tangible personal property in New York, and no Wascana employee, agent or representative was based in (or working in) New York.

The New York Division of Tax Appeals administrative law judge (ALJ) found that Wascana was not "carrying on business" in New York (within the meaning of New York's gross receipts tax statutes) even though Wascana systematically and continuously exploited the New York marketplace. Wascana's only physical presence in New York was from its brief ownership of gas in New York before it transferred title to its customers. The ALJ concluded that even if Wascana met the statutory nexus requirement of the New York gross receipts tax by "carrying on business" in New York, the Commerce Clause would still prohibit New York from imposing the gross receipts tax on Wascana's interstate sales of gas to New York customers. Citing *Quill,* the ALJ found it determinative that Wascana had no physical presence in New York, and *"Wascana's very brief ownership of the gas and transfer of title in New York is not sufficient to establish even a 'slightest presence' in New York. Therefore, imposition of the gross receipts tax on petitioner's sales is barred by the Commerce Clause."* The ALJ refused to place nexus significance on "flash title," that is, the location where title to the gas passed from Wascana to its customer.

In *Koch Fuels, Inc. v. Oklahoma,*[95] the taxpayer sold fuel oil at retail to Burlington Northern, Inc. Under the sales contract, title to the oil passed to Burlington Northern at an Oklahoma refinery connected to an interstate pipeline and Burlington Northern removed the fuel oil from the pipeline at points *outside* of Oklahoma. The Oklahoma Supreme Court determined (for Commerce Clause purposes) that Oklahoma could impose a sales-tax-collection obligation on those retail sales because (1) the point of delivery, (2) the transfer of title, and (3) transfer of possession occurred in Oklahoma under the contract and applicable commercial law.[96]

It is unclear that the Oklahoma Supreme Court would have allowed the state to impose an *income tax* on Koch as a result of its holding flash title to fuel oil in Oklahoma. State sales and use tax cases often assign great significance to F.O.B. points and retail sales contract terms because a sales tax only applies if the transfer of title or possession of tangible personal property occurred in the taxing state. On the other hand, the fact that title to the fuel oil transferred from Koch to Burlington Northern while the fuel oil was in transit through Oklahoma (with Burlington Northern taking possession of fuel oil at points outside of Oklahoma) did not necessarily mean that Koch derived *income* from sources in Oklahoma.

### *Attributional Nexus Principles*

In addition to advancing the argument that *Quill's* "bright line" physical presence standard only applies to sales and use taxes, some state administrators assert attributional nexus theories to assert nexus over out-of-state affiliates of in-state taxpayers. In creating a special purpose energy trading affiliate, a utility should be careful to provide the necessary personnel and equipment to the subsidiary or affiliate and to observe corporate law formalities to defend against the state's assertion of nexus over the energy trading affiliate. States will assert nexus over out-of-state businesses if an affiliated company present in the state is conducting activity on behalf of the out-of-state business or is not a separate legal entity for tax purposes.

## Agency

In *Lawrence Industries, Inc. v. Sharp,*[97] a Delaware holding company was found to have sufficient contact with Texas (by managing and directing the affairs of affiliates) to be subject to Texas's corporate franchise tax. In *Western Acceptance Company v. Florida,*[98] income tax nexus was attributed to an out-of-state

subsidiary ("Acceptance") that collected accounts receivable generated by its in-state parent ("Supply"), subjecting the out-of-state subsidiary to Florida's corporate income tax. In *Borders Online, LLC v. State Board of Equalization,*[99] the California Court of Appeals held that Borders Online (the internet sales subsidiary of the Borders retail group) had to collect California sales and use taxes on its interstate sales of merchandise because Borders Online was using in-state retail stores of Borders, the parent corporation, to accept returned merchandise and advertise on behalf of the Borders Online subsidiary. Similarly, two New York cases have found that trademark holding subsidiaries of both Sherwin-Williams and Lowe's Home Centers lacked economic substance and had no business purpose except to reduce income tax liability in New York and other separate return states.[100] Based on these findings, New York forced the parent corporations to file New York combined reports that included the royalty income of their trademark holding subsidiary.

On the other hand, in *Sherwin-Williams Co. v. Commissioner of Revenue,*[101] the Massachusetts Supreme Judicial Court determined that the restructuring of Sherman-Williams' intellectual property portfolio—including the transfer and licensing back of the domestic trademarks to Sherwin-Williams—had economic substance because it created viable business entities engaging in substantial business activity. The two trademark holding subsidiaries were not sham corporations; and the royalty payments to these subsidiaries were ordinary and necessary expenses of Sherwin-Williams.

Attributional nexus should be less of a concern for power and gas trading companies than it is for trademark companies and other types of passive income subsidiaries because these companies typically have substantial operations. Care must still be taken, however, if the power or gas trading company wants to avoid having nexus in a state, that an affiliated utility company, an unrelated agent, or an independent contractor does not conduct business activities on behalf of the power or gas trading company in the state. If such activities do take place, they can create nexus for the power or gas trading company in the state or states where the activities occur. The mere presence of affiliated utility companies in the state should *not* establish nexus for power or gas trading companies as long as affiliated companies do not conduct activities on behalf of the trading company.[102]

### *Nexus Observations*

## State Sales and Use Taxes

Under *Quill,* power and gas trading companies should only be required to collect the sales and use taxes of those states in which they have established physical presences. This means that trading companies are subject to sales and use tax collection obligations in those states where they maintain trading offices or other places of business; equipment or other tangible personal property; or have employees, agents or representatives or an affiliated company conducting in-state activity on behalf of the trading company.

If a trading company stores gas in third-party storage facilities for future sale, that activity will probably be viewed as the storage of inventory, which constitutes physical presence in the storage state.[103]

Financial trading activities, such as those documented under ISDA master agreements and other derivative contracts, should not result in nexus outside of the state where the energy trading company enters into these financial trading transactions. This is because the financially traded contracts do not provide for the delivery of physical commodities, instead determining profit or loss by reference to the prices of the underlying commodity.

An unsettled question is whether forward contracts give rise to physical presence nexus on the theory that the energy trading company acquired instantaneous "flash title" to the power or gas moving through the transmission grid or pipeline before it was sold and delivered to another party. A persuasive argument can be made under the *Wascana Energy* case (discussed above) that "flash title" should *not* establish physical presence in the state where flash title passes.[104] Energy trading companies can argue that in *Quill,* the mail order vendor did not have physical presence in North Dakota even though the state argued that the vendor held title to the goods until the common carrier (akin to an interstate pipeline or transmission grid) delivered the goods to the customer.

In general, sales and use taxes are not a significant compliance issue for power and gas trading companies that primarily make wholesale sales to counterparties. Under these circumstances, a power or gas trading company can request that its counterparties provide it with resale certificates to relieve it of the obligation to collect the delivery-point state's sales and use tax on wholesale transactions. Sales and use tax collection obligations can result, however, if a trading company makes *retail sales* to a commercial or consumer end-user.[105]

## Corporate Income/Franchise Taxes

State *income* taxes (and franchise taxes measured by net income of corporations "doing business" in the state) might be subject to a higher nexus standard under P.L. 86-272,[106] which prohibits state income taxes from being imposed on an out-of-state business with its only state contacts ancillary to the solicitation of orders for sales of *tangible personal property*, if the sales orders are accepted (or rejected) and filled by a common carrier or U.S. mail, from locations *outside* the taxing state. As is discussed above, P.L. 86-272 probably applies to natural gas, which is tangible personal property, but it is unclear whether power constitutes tangible personal property. The IRS has ruled that electricity is inventoriable property[107] but this does not necessarily answer the question of whether power is tangible or intangible property. In addition, the fact that a state's sales and use tax statutes define electricity as "tangible personal property" (so that retail sales of power will be subject to sales tax) does not necessarily mean that power is also treated as tangible personal property in the state's separate income and franchise tax laws. Nevertheless, a number of states treat power as tangible personal property to apportion (and tax) the income from inbound sales of power for delivery into that state. If state tax agencies take this administrative position to obtain a beneficial apportionment result, those state tax agencies also shall concede that power constitutes tangible personal property for purposes of the P.L. 86-272 nexus protection statute.

However, some state income tax administrators may contend that P.L. 86-272 still does not apply to physical trading transactions in which the power or gas commodity is delivered among the parties at the same delivery point on the theory that the parties are engaging in *intrastate* commercial transactions that are not covered by P.L. 86-272. In addition, because P.L. 86-272 only applies to state taxes on (or measured by) *net income*, the statute will have no application to other business activity taxes, such as the net worth components of the Ohio and Texas franchise taxes, the Michigan single business tax, the Washington business and occupation tax, the New Mexico gross receipts tax and the new Texas margins tax and Ohio commercial activity tax, which are replacing those two states' franchise taxes.

Some energy trading companies may argue that their forward contract transactions are really intangible trading transactions in which the parties have no interest in obtaining possession of the underlying energy commodity in the delivery-point state or anywhere else. In *Neste Oy Limited v. Department of Revenue and Taxation,*[108] the Louisiana Board of Tax Appeals accepted this argument for forward contract transactions that the taxpayer "closed" by reselling its right to receive delivery of natural gas to another counterparty *prior to the delivery date.* The company "did not take possession or delivery of the natural gas within the pipeline, *and it only bought and sold intangible contract rights.*" The Board of Tax Appeals found that these forward contracts had the same economic and tax consequences as financially settled transactions, which would be taxable only in the state where the company's trading employees executed such transactions.

## State Income Tax Issues

### *Apportionment of Income from Energy Trading Businesses*

Even if a power or gas trading company has income tax nexus in a state, it may not have significant tax liability if it has a small apportionment factor in the state. In the past—when electric power and natural gas were only sold by regulated utilities—apportionment issues were relatively simple to address because most energy sales were intrastate transactions. In addition, many states applied (and some still do) special gross receipts or franchise taxes, rather than the state's corporate income tax, to regulated utilities. Because power or gas trading companies are not typically regulated utilities, they are generally subject to state corporate income and franchise taxes. States are still adapting existing apportionment rules to such companies.

## Application of Apportionment Rules to Energy Trading Transactions

### *Natural Gas*

Because natural gas is tangible personal property, it is likely that the state in which gas was to be delivered under forward contracts will argue that the gross receipts from those forward contract sale transactions must be included in the numerator of the selling party's sales factor for the delivery-point state. Under a typical forward contract, the delivery point is the location where the seller transfers title, risk of loss and possession of the natural gas to the purchaser.

A gas trading company might be able to avoid application of the destination rule in the delivery point states, however, if the gas trading company can argue

that its forward contracts did not result in the actual delivery of gas between the parties because the gas trading company's counterparty has already entered into its own forward contract to resell the gas to another counterparty prior to the delivery date specified in the forward contract with the gas trading company (covered transactions). As discussed earlier, in *Neste Oy Limited v. Department of Revenue and Taxation,*[109] the Louisiana Board of Tax Appeals found that with respect to covered forward contract positions, the gas trading company taxpayer "did not take possession or delivery of the natural gas within the pipeline, and it only bought and sold intangible contract rights." As a result, the Board of Tax Appeals held that the gas trading company was not required to include its receipts from those "covered" forward contract positions in the numerator of its Louisiana sales factor. A gas trading company should be able to source its receipts from nonphysical trading transactions, that is, financially settled futures contracts and derivatives contracts, to the state where the company's trading employees are located, under the income-producing activity rule.

### *Electricity*

Power trading transactions raise a question as to whether electricity is tangible personal property under the state's income/franchise tax laws. If electricity is tangible personal property for state income/franchise tax purposes, the power trading company might be required to utilize the destination rule to source gross receipts from its forward-contract transactions to the state where the power is to be delivered under the forward contract. If the electricity is not tangible personal property (or if the forward contracts are considered to be intangible trading transactions), the income-producing activity rule would apply.

The leading case on the question of how the UDITPA sales factor sourcing rules apply to sales of power is *In the Matter of the Appeal of PacifiCorp.*[110] PacifiCorp, an Oregon power company, generated electricity at plants in Oregon, Washington, Montana, Wyoming and Utah, and sold its excess power capacity to wholesale and retail customers, with delivery being made through the Pacific Northwest-Pacific Southwest Intertie ("Intertie"), an interstate transmission grid that was owned by Portland General Electric and the Bonneville Power Administration. During the tax years at issue, PacifiCorp sold and delivered power over the Intertie to utilities, municipalities and government agencies in California. Under PacifiCorp's forward contracts, the delivery point along the Intertie (where PacifiCorp transferred title and risk of loss to the purchaser) was either at the Malin substation in Oregon or at the Oregon-Nevada border.

The California State Board of Equalization (SBE) had to determine whether the California Franchise Tax Board (FTB) had correctly included the gross receipts from PacifiCorp's wholesale sales of power to California customers in the numerator of PacifiCorp's California sales factor. For purposes of the California franchise tax, the SBE held that electricity is not tangible personal property, citing *Otte v. Dayton Power & Co.,*[111] a tort case where the Ohio Supreme Court determined that electricity was not a "product" within the meaning of the strict liability in tort provision of the Restatement of Torts. According to the *Otte* decision, electricity was not a "product" because it is not "made by human industry or art. … [E]lectricity is the flow of electrically charged particles along a conductor. [The power company] does not manufacture electrically charged particles, but rather, sets in motion the necessary elements that allow the flow of electricity. … Such a system is, in our view, a service."[112] Citing the *Otte* decision, the SBE reasoned that "the sales of electricity here are *sales of services* that essentially consisted of appellant's setting and keeping in motion, through its generation and transmission facilities, electrically charged particles. … we further conclude that the basic reason the generation and transmission process employed by appellant is appropriately *characterized as a service* is that the product does not result in either (1) the 'creation' in its generation facilities of any such arguably tangible particles or (2) the 'injection' of those particles into its transmission facilities."[113] After finding that electricity is *intangible* for California tax law purposes, the SBE held that PacifiCorp's gross receipts from generating and delivering electricity to California purchasers through the Intertie were non-California receipts under the income-producing activity rule of UDITPA.

In *Eua Ocean State Corp. v. Commissioner of Revenue,*[114] the Massachusetts Appellate Tax Board (ATB) adopted the *PacifiCorp* analysis, holding that the taxpayer was not required to include its gross receipts from sales of electricity to Massachusetts customers in the numerator of its Massachusetts sales factor. The ATB concluded that the taxpayer's gross receipts should be sourced to Rhode Island, the state where the taxpayer generated the electricity it sold. Even if the electricity had been tangible personal property (for Massachusetts corporate excise tax purposes), the ATB concluded that the gross receipts would still be sourced to Rhode

Island because the power sale agreements transferred title and risk of loss to the electricity at a point along the transmission grid in Rhode Island.

It is possible that some state income tax administrators may argue that the application of the income-producing activity sourcing rule in *PacifiCorp* and *Eua Ocean State* turned on the fact that the taxpayers were generating the power they sold in interstate commerce. If, on the other hand, a power trading company merely resells power (as a product or commodity), these state income tax administrators might contend that such power trading receipts should be sourced to the delivery state under the destination rule of UDITPA. Nevertheless, it is significant that California and Massachusetts both found that power is *not tangible personal property* for purposes of their state income and franchise taxes. If power is intangible personal property, the destination rule should not apply to apportion income from power trading transactions. Rather, the power trading company would source its trading receipts, under the income-producing activity rule, to the states in which it conducts its trading activities.

## State Positions on Sourcing Receipts from Power Trading Transactions

As might be expected, the states have not taken a uniform approach to apportioning power trading income. States have adopted a number of different approaches, including sourcing receipts from sales of electric power to (1) the state where the electric power is delivered; (2) the state where the trading activities occur; or (3) the state where the power purchaser is located. The particular apportionment rule depends, in part, on the type of activities that generate the receipts being sourced to state sales factors.

## Forward Contracts for the Sale of Power

Forward contracts for power provide for the purchase and sale, on a specified future date, of a stated amount of power, at a designated location (such as a designated power grid or power pool). In some instances, a power trading company makes "physical delivery" of power to a regulated utility that, in turn, sells the power to its retail customers. More commonly, power trading companies book-out their obligations by entering into offsetting forward contracts for the same date and delivery point as previously agreed to. For administrative convenience, these parties "book-out" their delivery obligations with the party owing the greater purchase liability making a cash payment to the other party. This results in financial settlement of the parties' respective purchase and sale obligations as a matter of administrative convenience. The underlying contracts provide for delivery of power and, according to the CFTC, book-outs do *not* transform forward contracts into futures contracts for purposes of federal commodities laws. The CFTC has also implied in several administrative pronouncements that legal title to the power passes to the purchasing party notwithstanding the book-out of the delivery obligation.

### *Sourcing Power Receipts As Sales of Tangible Personal Property*

A number of states treat electric power as tangible personal property for income and franchise tax purposes in order to use the *destination rule* to source the gross receipts from the forward contract sales of power. These states source sales of power to the state where the power was (or was to be) delivered according to the forward contract.[115] This allows states to tax the income from in-bound power sales, as the FTB attempted to do in *PacifiCorp*. It is also potentially allows the power trading company to assert that it does not have nexus in a state under P.L. 86-272.

If a state tax administrator follows the destination rule to source gross receipts from forward contract sales of power, this rule will usually apply even if the parties "book-out" delivery obligations. These state tax administrators recognize that book-outs are for administrative convenience and that the forward contracts themselves provided for physical delivery. Accordingly, these state tax administrators do not usually view booking-out of delivery obligations as converting forward contracts into intangible transactions.

The positions of a few of the larger states that apply the destination test to power trading companies are summarized below.

### *New York*

In New York, a power trader is subject to the Article 9-A corporate franchise tax, at a rate of 7.5 percent, on the greatest of the taxes on the apportion entire net income, capital or minimum taxable income bases or the fixed dollar minimum. New York currently uses a three-factor formula comprised of property, payroll and double-weighted sales to apportion the entire net income of multistate businesses.[116]

In the past, the New York Department of Taxation and Finance has informally indicated to the authors that a power trader should source forward contract

receipts to the numerator of the New York receipts factor based on the point where *power delivery* occurs.[117] In 2002, New York State adopted a special receipts factor rule for principal trades (which would include derivatives) of taxpayers that are registered securities or commodities brokers or dealers.[118] Under this rule, gross income, including any accrued interest or dividends, from principal transactions for the purchase of stocks, bonds, foreign exchange and other securities or commodities *(including futures and forward contracts, options and other types of securities or commodities derivatives contracts)* are sourced to the numerator of the New York receipts factor (1) to the extent that production credits are awarded to branches, offices or employees of the taxpayer within New York as a result of such principal transactions, or (2) if the taxpayer so elects, to the extent that the gross proceeds from such principal transactions are generated from sales of securities or commodities within New York based on the mailing address of such customers in the taxpayer's books and records.

### *Ohio*

Since 2002, Ohio has taxed power companies under the Ohio corporation franchise tax instead of from the public utility excise tax. The Ohio franchise tax currently applies a three-factor formula of property (20 percent), payroll (20 percent) and sales (60 percent) factors.[119] Ohio Revised Code Section 5733.059 provides special sales factor rules for power companies that distinguish between sales of electric transmission and distribution services as opposed to sales only of power. If the power company transmits or distributes power as an electric utility, the company uses a wire mileage ratio to determine its Ohio sales factor.[120] If, on the other hand, the company only sells power (as a power trading company), the company is required to source its power sales to the numerator of the Ohio sales factor to the extent that (1) the customer consumes the power in Ohio; or (2) the seller (or the seller's related member) directly or indirectly delivers the power to a location in Ohio or at the Ohio border.[121] In effect, Ohio is using the destination rule to source receipts from power sales.

Beginning in 2006, Ohio started phasing out (over a five-year period) its corporation franchise tax, at a rate of 20 percent per year, and replacing it with the Ohio Commercial Activity Tax (the Ohio CAT).[122] The Ohio CAT is levied on each person with taxable gross receipts from doing business in Ohio. Gross receipts from the sale of power and electric transmission and distribution services are sourced to Ohio under the Ohio CAT statutes in the same way that they are under the corporation franchise tax.[123] As a result, it appears that Ohio continues to rely on the delivery point in forward contracts to source a power trading company's receipts for sales of power.

### *Virginia*

Effective with tax years commencing on or after January 1, 2001, electric suppliers, pipeline distribution companies and gas utilities and suppliers are subject to the Virginia corporate income tax instead of the former license tax on gross receipts.[124] The Virginia corporate income tax is imposed at a rate of six percent on income apportioned to Virginia with a three-factor formula of property, payroll and sales factors.[125] Electricity is defined as tangible personal property for purposes of the Virginia corporate income tax.[126] Accordingly, Virginia now includes sales of power in the numerator of the Virginia sales factor if the power is delivered to customers at points in Virginia.

### *Sourcing Power Receipts As Sales of Services or Intangibles*

State tax administrators may, on the other hand, take the position that forward contracts for power sales are intangible personal property and that the gross receipts from such trading are sourced to the state where the "income-producing activity" occurs, based on cost of performance or, in the case of Texas, where the buyer of the power is incorporated.

### *California*

The California SBE now applies the income-producing activity to power trading transactions as a result of its decision in *PacifiCorp*.

### *Illinois*

Illinois follows the income-producing activity rule to source power trading gross receipts to the Illinois sales factor. This position is based on the Illinois Department of Revenue's longstanding administrative position that power is not tangible personal property for Illinois sales tax and other tax purposes. Natural gas, on the other hand, is treated as tangible personal property. As a result, the Illinois Department of Revenue has informally stated to the authors that it would apply the destination rule to source receipts from forward contracts for sales of natural gas.[127]

### *Texas*

Texas actually uses the destination rule to apportion income resulting from sales transactions where power is delivered to customers. But, Texas treats "daisy chain" forward contracts and other trading transactions as intangibles, using the "location of payor" rule to source gross receipts to the receipts factor of the Texas corporation franchise tax.[128] This means that Texas sources net gains from sales of investments and capital assets to the state where the payor is incorporated or organized.[129] For example, in TR 1349, the taxpayer entered into swap agreements to hedge its long-term gas sales and supply contracts. The Texas Comptroller of Public Accounts ruled that the taxpayer should source its gross receipts for these gas sales to the Texas receipts factor based on the location of the gas purchaser. If the purchaser was organized in a state other than Texas, the receipts would be included in the denominator but not the numerator of the Texas receipts factor. Texas' sourcing rule presents tax savings opportunities for power traders because it appears they can apportion income from forward contracts with non-Texas parties outside of Texas, even if the forward contract specified a delivery point in Texas.

Effective with the 2008 report year, Texas is replacing the corporation franchise tax with a new "margin tax."[130] At the date of this writing, it is not clear how receipts from forward contracts of power trading companies will be sourced to the Texas margin tax receipts factor. If the Texas Comptroller retains the "location of payor" rule for the margin tax, power traders will not have to change this apportionment methodology in Texas.



## Options and Other Financial Products

States generally use the income-producing activity test to apportion income from OTC options, derivatives and other financial products involving electricity or natural gas. Because these financial products do not provide for delivery of the underlying energy commodity, states typically view these transactions as involving intangibles rather than the sale of tangible personal property. Texas applies the "location of the payor" rule to trading options and similar financial products. It has not adopted the income-producing activity test.

### *Measure of the Sales Factor*

A power or gas trading company also must consider whether it will include the *gross receipts* or *net gain* from its energy trading transactions in its state sales factors. Some state tax administrators contend that if a taxpayer engages in frequent short-term investment transactions unrelated to its core business, the taxpayer should include only the net income or gain from the trading transactions in its sales factor to avoid distortion of the apportionment of income from its core business. These administrators argue that including the returned principal from the trading transactions in the denominator (but not the numerator) of the sales factor would unreasonably dilute the sales factor.[131] Some courts have rejected this argument noting that a state's sales factor statute expressly provides that the sales factor includes the taxpayer's "gross receipts."[132] States should have little reason to assert this argument against power trading companies where the power trading transactions are the company's core business and inclusion of gross receipts will not distort the sales factor.

A related question is whether power traders should include in their sales factor the *net* payments they receive from book-out transactions. Conceptually, the net payment received from "book-out" transactions is not the proper measure of the sales factor because the net payment figure takes into account amounts that party owed to its counterparty for power purchases. The Texas Comptroller of Public Accounts has recognized this point, ruling in TR 1349[133] that where a taxpayer entered into swap agreements for the purchase and sale of natural gas, the taxpayer was to include the gross receipts due to the taxpayer under the swap agreements in its Texas apportionment factor. The Texas Comptroller concluded that "[t]he payments Taxpayer makes have no effect on gross receipts (there is no such thing as a negative receipt)," and the Texas Comptroller has informally indicated to the authors that TR 1349 applies to book-out transactions involving power and gas.

## Sales and Use Tax Issues

A regulated electric utility has fairly well-understood sales and use tax issues. Its retail sales of electric power and the purchase of fuel and equipment to produce the electric power may or may not be taxable, depending on the laws of the state where it operates. The same point could be made for regulated gas utilities.

The sales and use tax issues are more complex for an energy trading company that buys and sells the electric power or gas as a commodity or contracts for the production of such commodities.

# Are Sales of Power or Gas Subject to Sales Tax?

## Forward Contracts for Delivery of Power or Gas

When is the sale of power or gas subject to state sales and use tax? If a power trading company enters into a forward contract to purchase a specified quantity of power, at a stated price, *for delivery on a stated date in the future*, an aggressive state tax administrator might assert that because the power trading company is contractually obligated to purchase the power, the sales tax is due when the purchase contract is executed, not when the commodity is delivered. Some states have issued rulings, however, that treat such a contract transaction as an exempt purchase of *intangible* personal property without attempting to tax the transaction until delivery actually takes place.

In N.Y. TSB-M-81(4)S,[134] for example, transactions involving the trading of futures contracts for precious metals were not subject to New York sales and use tax because the futures contracts were intangibles. The New York Department of Taxation and Finance ruled, however, that if the futures contract was not traded prior to maturity (and a transfer of title or possession of the commodity occurred), this would be a taxable event for sales and use tax purposes. In Illinois Priv. Ltr. Rul. 85-0104[135] and Priv. Ltr. Rul. 82-0252,[136] the Illinois Department of Revenue ruled that, in general, no sales and use tax is imposed on the purchase of a commodity futures contract until the owner of the contract actually takes possession of the commodity. In addition, California Reg. 1599(b)(3) provides that futures contracts for the purchase or sale of a commodity are not subject to sales and use tax until title or possession of the commodity is transferred.

When physical delivery is made under a forward contract, the contract parties need to determine whether retail sales of power or gas are even subject to sales or use tax in the delivery state. Some states exempt power and gas from their sales and use tax based on legislative determinations that basic utility services should not be taxed. A number of states, however, do impose sales and use taxes on retail sales of power and gas or limit the exemption for such utility service transactions, for example, to specified amounts of power or gas sold to consumers. Some states (such as Illinois) exempt retail sales of power or gas from the general sales and use tax and instead apply special excise taxes to such utility service transactions.[137]

Even if the delivery point state does tax retail sales of power or gas, a forward contract does not give rise to sales or use tax collection liability if the party purchasing the electricity or gas plans to resell the commodity to another trader, utility or commercial customer under another forward contract or supply agreement. All state sales and use tax laws have exemptions for resales, although some states require that the purchasing party be registered in the state in order for it to be able to provide a valid resale certificate.

An energy trading company may be able to claim other sales or use tax exemptions, such as a manufacturing exemption or the charitable or government exemptions, depending on the customer purchasing the gas or power. Alternatively, the energy trading company may be able to claim a temporary storage exemption or interstate exemption if the power or gas is merely moving through a wire or pipeline in the state.

If the energy trading company sells power or gas to commercial or residential customers for their use, the energy trading company should determine whether it is required to collect and remit sales or use tax on the retail sales transaction. In this era of deregulated energy markets, power and gas trading companies increasingly sell power or gas directly to consumers as "alternative suppliers" or in some similar capacity, with the local utility providing transmission or distribution services to the consumer. Whether the energy trading company is required to collect and remit sales or use tax on the retail sale transaction can depend on a number of factors, including whether the company has a billing relationship with the consumer.

### *Option Contracts for Purchase of Electric Power or Gas*

If an energy trading company enters into option contracts and other financial products that do not commit the company to making actual purchases of power unless the company exercises the option, states generally will *not* impose a sales or use tax on the purchase and sale of the contract.[138]

### *State Use Tax on Tolling Transactions*

Trading companies frequently enter into tolling agreements with owners of generation plants to generate power that the company sells at wholesale to electric utilities, commercial customers, or other power trading companies. Under tolling agreements, the company typically provides natural gas to the plant owner to consume while generating power belonging to the trading company. The trading company is

probably viewed as the consumer of this gas because the power is being produced for it. This will subject the trading company to state sales and use tax on the gas unless the state where the power is generated has an exemption for consumption of the gas.

A number of exemptions might apply. First, if the state's sales and use taxes treat the generation of power as manufacturing tangible personal property for sale, the gas may be exempt from sales and use tax as a manufacturing input. The manufacturing exemption probably will not apply, however, if the state does not tax retail sales of power or if power is considered to be intangible personal property for sales and use tax purposes. In addition, some states, such as Maine, provide only partial exemptions or a reduced sales tax rate for fuel used to generate electricity.[139]

Second, some states provide an explicit sales and use tax exemption for gas used to generate electricity. New York, for example, provides a sales and use tax exemption for "fuel, *gas*, electricity, refrigeration … for use or consumption directly and exclusively in the production of tangible personal property, gas, *electricity*, refrigeration or steam for sale by manufacturing, processing, assembling, *generating*, refining, mining or extracting."[140]

California sales and use tax laws provide an exemption for "gas, electricity, and water, including steam and geothermal steam, brine and heat, when delivered to consumers through mains, lines or pipes."[141] In *County of Sonoma v. State Board of Equalization,*[142] the California Court of Appeals held that the California sales and use tax did not apply to sales of geothermal steam delivered to a California utility through pipelines for its use in generating electricity. Connecticut provides a similar exemption for "the furnishing of gas, water, steam or electricity when delivered to consumers through mains, lines or pipes."[143] In Conn. Rev. Ruling 2004-2,[144] purchases of gas qualified for the Connecticut sales and use tax exemption for gas used in generating electricity for sale to wholesalers or remarketers.

Purchasers of gas used to produce electricity at a plant in Illinois might be able to avoid tax liability if they acquire title to the gas at a delivery point outside Illinois. For many years, retail sales of gas have been subject to the Illinois Gas Revenue Tax[145] instead of the Illinois Retailer's Occupation Tax[146] and use tax.[147] The Gas Revenue Tax is imposed on persons engaged in the business of distributing, supplying, furnishing or selling gas in Illinois to persons for use or consumption and not for resale, at a rate of 2.4 cents per therm or five percent of the gross receipts received from the sale of the gas, whichever is lower.[148] Utilities and other gas retailers in Illinois pass the cost of the Gas Revenue Tax through to their customers. The Gas Revenue Tax does not apply to sales in interstate commerce, and the Illinois Department of Revenue has interpreted this interstate sale exemption to apply if the consumer acquires title to the gas from the seller at a point outside Illinois and the sale transaction arose outside the state.[149] If the consumer acquired title to the gas at a point outside Illinois there is no Gas Revenue Tax liability for the retailer to pay (and pass through to the consumer), and for many years there was no compensating use tax on gas that the retailer could be required to collect from the customer.

Effective October 1, 2003, the Illinois General Assembly enacted the Illinois Gas Use Tax,[150] which is imposed on the Illinois consumer for using gas purchased outside of Illinois.[151] Gas suppliers with Illinois nexus must collect the Gas Use Tax from their Illinois customers at a rate of 2.4 cents per therm of gas used in Illinois. Customers that elect to self-assess the Gas Use Tax must pay the tax directly to the Department at a rate of five percent of the purchase price of the gas or 2.4 cents per therm, whichever is less.[152] Significantly, the Gas Use Tax Act provides an exemption for gas used in the production of electric energy in Illinois.[153] This exemption is *not* available under the Illinois Gas Revenue Tax Act. As a result, if a power trading company acquires title to the gas that it supplies for use in connection with a tolling agreement in Illinois at a delivery point outside Illinois, the Gas Revenue Tax should not apply because these will be out-of-state purchases, and the Gas Use Tax will not apply because of the exemption described above. On the other hand, if the power trading company takes title to the gas in Illinois, the supplier may incur Gas Revenue Tax that it will presumably pass through to the power trading company.

## Conclusion

Participants in the various energy derivatives markets face complex federal and state tax rules. On the federal side, tax character and timing can vary among products based on economically irrelevant factors as well as the characterization of the taxpayer (as a dealer, hedger, trader or investor). In addition,

complications can result if a taxpayer improperly hedges risk or improperly identifies a hedge, possibly triggering the tax character whipsaw rules. Thus, to simplify tax identifications and to avoid character and timing mismatches, commodities dealers and traders often consider whether they should make a Code Sec. 475 mark-to-market election, resulting in ordinary income and loss for all physical and financial commodity transactions. To the extent that the taxpayer enters into long-term physicals or derivative transactions, a Code Sec. 475 election may accelerate gains that may not actually be realized in the future. Thus, a proper understanding of the taxpayer and the types of derivative transactions they enter into is critical in choosing the most optimal federal tax strategy.

On the state side, the taxpayer will probably have state income and franchise tax and sales and use tax filing obligations in states in which the taxpayer maintains an office, employees, agents, or representatives or tangible property, including natural gas stored in facilities in the state for eventual resale. It is unclear, however, whether the taxpayer will acquire taxable nexus in states based on other contacts such as holding "flash title" to electricity or natural gas at a delivery point or on a transmission grid or pipeline in the state. There are good arguments that the taxpayer should not acquire taxable nexus under such circumstances, but the courts have not yet really addressed this issue.

> If the taxpayer does establish income and franchise tax nexus in a state, the taxpayer will need to apportion its income to the state utilizing sales factor sourcing rules that are still being developed in many states.

If the taxpayer does establish income and franchise tax nexus in a state, the taxpayer will need to apportion its income to the state utilizing sales factor sourcing rules that are still being developed in many states. For example, depending on the state involved, the taxpayer could be required to source receipts from forward contracts to the numerator of the state's sales factor if the delivery point specified in the forward contract was in the state, if the trading activity relating to the forward contract occurred in the state, or if the taxpayer's counterparty was located in the state.

State sales and use tax issues are not as problematic, but taxpayers engaging in tolling transactions could incur substantial use tax liability with respect to the natural gas that they supply to the owner of the generation facility if this issue is not handled correctly.



## Endnotes

1 IntercontinentalExchange Inc. Form 10-K, filed March 10, 2006.
2 On March 27, 2006, SFE and ASX announced a merger proposal in which SFE would become a wholly owned subsidiary of ASX. On May 24, 2006, the Australian Competition and Consumer Commission (ACCC) announced that it would not oppose the merger.
3 A noncompete agreement between NYMEX and CME was in place until June 2006. As of June 12, 2006, CME started offering various NYMEX energy products (although electricity futures contracts were not being offered at the date of this writing).
4 Source, although important for cross-border taxpayers and transactions, is not discussed in this article.
5 Code Sec. 1221(a)(1).
6 Code Sec. 1221(a)(2).
7 Code Sec. 1221(a)(3).
8 Code Sec. 1221(a)(4).
9 Code Sec. 1221(a)(5).
10 Code Sec. 1221(a)(6).
11 Code Sec. 1221(a)(7).
12 Code Sec. 1221(a)(8).
13 This article does not discuss in detail the tax character and timing rules that apply to tax straddles. In general, however, the straddle rules limit the amount of loss a taxpayer may recognize and limits the taxpayer's holding period in property, preventing the taxpayer from creating artificial tax losses and from converting short-term capital gains into long-term capital gains.
14 Code Sec. 1092(c)(1).
15 Code Sec. 1092(d)(1).
16 Staff of the Joint Comm. on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981, at 289 (Joint Comm. Print 1981).
17 *Id.*
18 Code Sec. §1256(f)(2) and 1256(e)(1).
19 Code Sec. 1256(b).
20 Code Sec. 1256(g)(1).
21 Code Sec. 1256(g)(7).
22 Code Sec. 1256(g)(3).
23 Code Sec. 1256(g)(5).
24 Code Sec. 1256(g)(6).
25 Code Sec. 1234(a)(1).
26 Reg. §1.446-3(c)(1)(i).
27 Reg. §1.446-3(e)(2)(i).
28 Reg. §1.446-3(f)(1).
29 Reg. §1.446-3(f)(2)(i).
30 *Id.*
31 Reg. §1.446-3(h)(1).
32 Reg. §1.446-3(h)(2).
33 Code Sec. 475(e)(2)(A).
34 Code Sec. 475(e)(2)(D).
35 Reg. §1.1502-13(c)(2); Reg. §1.1502-13(c)(7)(ii), Example 11.
36 Exceptions are provided for commodities "held for investment," "not held for sale," or "hedges" of commodities that are themselves exempt from mark-to-market. These exceptions are not available if the taxpayer also makes a commodity "trader" election.
37 Code Sec. 475(f)(1)(B).
38 Code Sec. 1221(a)(6).
39 Code Sec. 1221(b)(1)(A).
40 *Id.*
41 As defined in Code Sec. 1256(g)).
42 Code Sec. 1221(b)(1)(B)(i).
43 Code Sec. 1221(b)(3).
44 Code Sec. 1221(b)(2)(A); Reg. §1.1221-2(b).

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45 Reg. §1.1221-2(c)(1).
46 Code Sec. 1221(b)(2).
47 Reg. §1.1221-2(f)(3)(i) (emphasis added).
48 Reg. §1.1221-2(c)(4)(i).
49 *Id.*
50 Reg. §1.1221-2(d)(1)(ii)(A).
51 Reg. §1.1221-2(d).
52 Reg. §1.1221-2(d)(1)(iii); this particular risk reduction transaction is considered to manage taxpayer's risk. *See* Reg. §1.1221-2(d)(1)(i)("In general. A transaction that is entered into to reduce a taxpayer's risk, manages a taxpayer's risk").
53 Reg. §1.1221-2(d)(1)(iv); this particular risk reduction transaction is also considered to manage taxpayer's risk. *See* Reg. §1.1221-2(d)(1)(i).
54 Reg. §1.1221-2(d)(2).
55 Reg. §1.1221-2(d)(3).
56 Reg. §1.1221-2(d)(4).
57 Reg. §1.1221-2(d)(7)(i).
58 Reg. §1.1221-2(d)(7)(ii).
59 Reg. §1.1221-2(c)(4)(ii).
60 *Id.*
61 Reg. §1.1221-2(d)(6).
62 Reg. §1.1221-2(c)(2).
63 Reg. §1.1221-2(c)(2).
64 Code Sec. 1221(a)(8).
65 Reg. §1.1221-2(d)(5).
66 An identification that satisfies Code Sec. 1221(a)(7) and Reg. §1.1221-2(f) is treated as an identification for purposes of Code Sec. 1256(e)(2) and Reg. §1.1256(e)-1. Identification as a hedge for purposes of Code Sec. 1256(e) avoids application of the straddle rules of Code Sec. 1092.
67 Code Sec. 1221(b)(2)(B); Reg. §1.1221-2(g).
68 Reg. §1.1221-2(f)(2)(i).
69 Code Sec. 1221(a)(7); Reg. §1.1221-2(f)(1).
70 Reg. §1.1221-2(f)(2)(ii). This substantially contemporaneous rule is not a 35-day safe harbor.
71 Code Sec. 1221(b)(2)(B); Reg. §1.1221-2(g).
72 Reg. §1.1221-2(f)(5).
73 Reg. §1.1221-2(e)(1).
74 Reg. §1.1221-2(e)(2).
75 Reg. §1.1221-2(f)(5)(ii).
76 Reg. §1.1221-2(e)(2)(iii) and Reg. §1.1221-2(g)(3).
77 Reg. §1.446-4
78 Reg. §1.446-4(b).
79 Reg. §1.446-4.
80 A section 1256 contract is defined as a "regulated futures contract," an exchange traded "non-equity option," an interbank "foreign currency contract," or a "dealer non-equity option." For a discussion of Code Sec. 1256, *see* discussion above.
81 Reg. §1.1256(e)-1(c).
82 *Mobil Oil Corp. v. Comm'r of Taxes of Vermont,* SCt, 445 US 425, 100 SCt 1223 (1980).
83 *Quill Corp. v. North Dakota,* 504 US 298, 112 SCt 1904 (1992).
84 *Complete Auto Transit, Inc. v. Brady,* 430 US 274, 97 SCt 1076 (1977).
85 *Geoffrey, Inc. v. S.C. Tax Comm'n,* SC SCt, 313 SC 15, 437 SE2d 13 (1993). *Cert. denied,* 510 US 992, 114 SCt 550 (1993).
86 Interstate Income Tax Law (P.L. 86-272) 15 USC §381 *et seq.*
87 *Geoffrey, Inc., supra* note 85.
88 The court also found that Geoffrey maintained two types of intangibles in South Carolina: (1) the license of the trademarks and (2) receivables for unpaid royalties from its trademark licenses.
89 *J.C. Penney National Bank v. Johnson,* TennCtApp, 19 SW3d 831 (1999). *Cert. denied,* SCt, 531 US 927, 121 SCt 305 (2000).
90 *Rylander v. Bandag Licensing Corp.,* TexCtApp, 18 SW3d 296 (2000).
91 *See A&F Trademark, Inc. v. Tolson,* NCCtApp, 167 N.C. App. 150, 605 S.E.2d 187 (2004). *Cert. denied,* 126 S. Ct. 353 (2005); *Lanco, Inc. v. Director, Division of Taxation,* NJAppDiv, 379 NJSuper 562, 879 A2d 1234 (2005). *Aff'd,* N.J. SCt, 188 NJ 380, 908 A2d 176 (2006); *Dep't of Revenue v. Gap (Apparel), Inc.*, LaCtApp., 886 So2d 459 (2004) (the Louisiana Court of Appeals denied the defendant trademark holding subsidiary's affirmative defense that it did not have personal jurisdiction in Louisiana as a result of licensing its trademarks to its affiliated companies for use in retail stores in Louisiana without addressing the issue of whether the trademark subsidiary had nexus in Louisiana under the Commerce Clause since it was not relevant to the personal jurisdiction issue); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, OklaCtApp, 132 P.3d 632 (2005) (the Oklahoma Court of Appeals held that the *Quill* physical presence nexus standard does not apply to state corporate income taxes and that by licensing intangibles for use in Oklahoma and receiving income in exchange for their use, the trademark holding subsidiary had purposely directed its activities toward Oklahoma residents, thereby creating Due Process nexus in Oklahoma); *Kmart Corp. v. New Mexico Taxation and Revenue Dep't*, N.M. SCt, 131 P.3d 22 (2005) (the New Mexico Supreme Court unanimously held that under the wording of the New Mexico gross receipts tax statute, the tax did *not* apply to royalty receipts that Kmart Properties, Inc., the trademark holding subsidiary of Kmart Corp., earned from granting a trademark license to Kmart at a location outside New Mexico, but the New Mexico Supreme Court let stand the New Mexico Court of Appeals decision on the corporate income tax issue in the case, which had held that the *Quill* physical presence nexus standard did *not* apply to the New Mexico corporate income tax and, even if it did, that Kmart Properties had "the functional equivalent of physical presence" as a result of Kmart's use of the licensed trademarks in its retail stores in New Mexico).
92 *Steager v. MBNA America Bank, N.A.,* No. 04-AA-157, WVaCirCt), [W.Va.] St. Tax Rep. (CCH) ¶400-399, June 27, 2005.
93 *Tax Commissioner of West Virginia v. MBNA America Bank, N.A.,* 640 S.E.2d 226 (W.Va. Nov. 21, 2006).
94 *In the Matter of the Petition of Wascana Energy Marketing (U.S.), Inc.,* N.Y. Div. Tax App., DTA No. 817866 (July 18, 2002), [N.Y.] St. Tax Rep. (CCH) ¶404-251.
95 *Koch Fuels, Inc. v. Oklahoma,* Okla. SCt, 862 P.2d 471 (1993).
96 *Id.,* at 480.
97 *Lawrence Industries, Inc. v. Sharp,* TexAppCt, 890 SW2d 886 (1994).
98 *Western Acceptance Company v. Florida,* FlaApp, 472 So2d 497 (1985).
99 *Borders Online, LLC v. State Bd. of Equalization,* 129 CalApp 4th 1179, 29 CalRptr 3d 176 (2005).
100 In the Matter of the Petition of Sherwin-Williams Co., N.Y. Tax App. Trib., DTA No. 816712, [N.Y.] St. Tax Rep. (CCH) ¶404-563 (June 5, 2003), *aff'd,* 12 A.D.3d 112, 784 N.Y.S.2d 178 (2004), app. denied, 4 N.Y.3d 709 (2005); *In the Matter of the Petition of Lowe's Home Centers, Inc.*, N.Y. Div. Tax App., DTA No. 818411 (Sept. 30, 2004), [N.Y.] St. Tax Rep. (CCH) ¶404-922.
101 *Sherwin-Williams Co. v. Comm'r of Revenue,* Mass. SCt, 778 N.E.2d 504, 438 Mass. 71 (2002).
102 *See, e.g., SFA Folio Collections, Inc. v. Tracy,* 73 Ohio St. 3d 119, 652 N.E.2d 693 (1995); *Bloomingdale's By Mail Ltd., v. Pennsylvania Dep't of Revenue,* Pa. Commw., 130 Pa. Commw. 190, 567 A.2d 773 (1989). *Aff'd,* Pa. Commw., 527 Pa. 347, 591 A.2d 1047 (1991); *Current, Inc. v. California State Bd. of Equalization,* Cal. App., 24 CalApp4th 382, 29 CalRptr2d 407 (1994).
103 *Cf Exxon Corp. v. San Patricio County*, Tex. Ct. App., 22 S.W.2d 269 (1991) (county was allowed to assess its property tax on oil that Exxon stored in tanks for 17 days before the oil was shipped out of Texas *via* an interstate pipeline); *Diamond Shamrock Refining & Marketing Co. v. Nueces County Appraisal District*, Tex. SCt, 876 S.W.2d 298 (1994) (Texas Supreme Court upheld the assessment of a local property tax on oil that was imported into the United States through the Gulf of Mexico and delivered

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to a Diamond Shamrock refinery in the taxing county; the Texas Supreme Court suggested that property taxes could not have been imposed on oil that was merely passing through Texas through an interstate pipeline).

104 *But note* the *Koch Fuels, Inc. v. Oklahoma* case discussed above concluded that sales/use tax collection nexus was established as a result of Koch transferring title and possession to fuel oil to Burlington Northern at an f.o.b. point in Oklahoma. *See also Koch Fuels, Inc. v. Clark*, R.I. SCt, 676 A2d 330 (1996) (the Rhode Island Supreme Court affirmed a gross-earnings tax assessment on an out-of-state corporation that shipped fuel oil into Rhode Island via vessels because Koch retained title, possession and risk of loss over the fuel oil up until the point where the fuel reached the flange in Providence and because Koch's fuel oil represented the entire cargo of the vessel).

105 Some state sales tax laws treat sales of power or gas as an exempt service.

106 Interstate Income Tax Law (P.L. 86-272), 15 USC §381 *et seq.*

107 LTR 9523001 (Dec. 17, 1994). *Revoked by* LTR 9527003 (Feb. 15, 1995).

108 La. BTA No. 5079 (Feb. 22, 2006) (emphasis added).

109 La. BTA No. 5079 (Feb. 22, 2006).

110 *In the Matter of the Appeal of PacifiCorp.,* Cal. SBE, No. 90027 (Sept.12, 2002), [Cal.] St. Tax Rep. (CCH) ¶403-326.

111 *Otte v. Dayton Power & Co.,* Ohio SCt, 37 Ohio St3d 33, 523 NE2d 835 (1988).

112 *Id.,* at 37.

113 *PacifiCorp, supra* note 110, at 22 (emphasis added).

114 *Eua Ocean State Corp. v. Comm'r of Revenue,* Mass. App. Tax Bd., 2006 Mass. Tax LEXIS 35 (Apr. 24, 2006).

115 *See Indiana-Kentucky Electric Corp. v. Indiana Dep't of State Revenue,* Ind. SCt, 598 NE2d 647 (1992).

116 New York State (but not New York City) is phasing in a single sales factor apportionment formula with tax years beginning on or after January 1, 2006.

117 N.Y. Tax Law §210(3)(a)(2)(D).

118 N.Y. Tax Law §210(3)(a)(9)(A)(iii).

119 Ohio Rev. Code §5733.05(B)(2).

120 Ohio Rev. Code §5733.059(B).

121 Ohio Rev. Code §5733.059(D).

122 Ohio Rev. Code §5751.01 *et seq.*

123 Ohio Rev. Code §5751.033(C).

124 Va. Code §58.1-400.2.

125 Va. Code §58.1-400.

126 Va. Code §58.1-400.2(C).

127 Fewer states appear to use the income-producing activity rule than the destination rule for apportioning income of energy trading businesses. This may be because the income-producing activity rule tends to benefit a limited number of states where the energy trading company conducts its trading activities. It will be interesting to see whether more states start to use the income-producing activity rule now that the Massachusetts Appellate Tax Board has joined the California SBE in finding that the destination rule does not apply to power sales.

128 Texas Comptroller of Public Accounts, TR 1349 (STAR System 9606044T) (June 11, 1996); Texas Comptroller of Public Accounts Administrative Dec. No. 200302889P (Feb. 14, 2003).

129 34 Tex. Admin. Code §§3.549(b)(7), 3.549(e)(13), 3.557(b)(9) and 3.557(e)(13).

130 Tex. Tax Code §171.101 *et seq.,* as enacted by Tex. L. 2006, H.B. 3.

131 Cases in which the courts accepted this argument by the states include *Microsoft Corp. v. Franchise Tax Bd.*, Cal. SCt, 39 Cal4th 750, 139 P3d 1169, 47 CalRptr3d 216 (Aug. 17, 2006); *General Motors Corp. v. Franchise Tax Bd.*, Cal. SCt, 39 Cal4th 773, 139 P3d 1183, 47 CalRptr 3d 233 (Aug. 17, 2006); *American Telephone & Telegraph Co. v. State Tax Appeal Bd.*, Mont. SCt, 241 Mont 440, 787 P.2d 754 (1990); *Sherwin-Williams Co. v. Indiana Dep't of State Revenue*, Ind. Tax Ct., 673 N.E.2d 849 (1996); *Sherwin-Williams Co. v. Johnson*, Tenn. App., 989 S.W.2d 710 (1998); *Appeal of Toys 'R' Us, Inc.*, Cal. SBE, Decision, 49612, CA-TAXRP-TR20010518074 (Apr. 19, 2001).

132 *Sherwin-Williams Co. v. Dep't of Revenue,* Ore. SCt, 329 Ore. 599, 996 P.2d 500 (2000); *Miami Corp. v. Dep't of Revenue,* Ore. Tax Ct., 2005 Ore. Tax LEXIS 23 (Feb. 17, 2005); *AT&T v. Dep't of Revenue,* Ore. Tax Ct., No. 4438 2000 Ore. Tax LEXIS 17, [Ore.] St. Tax Rep. (CCH) ¶400-341 (Aug. 31, 2000); *Pennzoil Co. v. Dep't of Revenue,* Ore. Tax Ct., No. 4301, 2000 Ore. Tax LEXIS 6, [Ore.] St. Tax Rep. (CCH) ¶400-322 (Mar. 17, 2000); *Appeal of Fuji Bank, Ltd.,* Cal. SBE (Aug. 31, 2000); *In the Matter of the Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.,* Cal. SBE, [Cal.] St. Tax Rep. (CCH) ¶401-740 (June 2, 1989).

133 STAR System 9606044T (June 11, 1996). Available at *http://cpastar2.cpa.state.tx.us/highlight/index.html?url=http%3A//aixtcp.cpa.state.tx.us/opendocs/open17/9606044t.html&fterm=9606044T&la=en&charset=iso-8859-1&search=../query.html%3Fqt%3D9606044T%26ql%3D.*

134 N.Y. TSB-M-81(4)S (Feb. 20, 1981).

135 Illinois Priv. Ltr. Rul. 85-0104, 1985 Ill. PLR LEXIS 110 (Jan. 30, 1985).

136 Illinois Priv. Ltr. Rul. 82-0252, 1982 Ill. PLR LEXIS 494 (Mar. 10, 1982).

137 *See* Illinois Public Utilities [Electricity] Revenue Act, 35 ILCS 620/1; Illinois Electricity Excise Tax, 35 ILCS 640/1 *et seq.*; Illinois Gas Revenue Tax Act, 35 ILCS 615/1 *et seq.*; Illinois Gas Use Tax, 35 ILCS 173/501 *et seq.*

138 *See, e.g.*, Cal. Reg. 1599(b)(3) ("options to buy" or "options to sell" are not subject to California sales/use tax until the option is exercised).

139 Me. Rev. Stat., tit. 36, §1760(9-D) (95 percent of the cost of fuel and electricity used in manufacturing is exempt from Maine sales and use tax).

140 N.Y. Tax Law §1115(c)(1) (emphasis added).

141 Cal. Rev. & Tax Code §6353(a).

142 *County of Sonoma v. State Bd. of Equalization,* 195 Cal. App. 3d 982; 241 Cal. Rptr. 215 (1987).

143 Conn. Gen. Stat. §12-412(8).

144 Conn. Rev. Ruling 2004-2,(June 18, 2004), available at *www.ct.gov/drs/cwp/view.asp?a=1513&q=277154*.

145 35 ILCS 615/1 *et seq.*

146 35 ILCS 120/1 *et seq.*

147 35 ILCS 105/1 *et seq. See* Illinois Priv. Ltr. Rul. ST 99-0118-GIL, [Ill.] St. Tax Rep. (CCH) ¶401-198 (Mar. 26, 1999).

148 35 ILCS 615/2.

149 *Id.*

150 35 ILCS 173/5-1 *et seq.*

151 35 ILCS 173/5-10.

152 *Id.*; Illinois Dep't of Revenue Bulletin FY 2004-09, [Ill.] St. Tax Rep. (CCH) ¶401-434 (July 1, 2003).

153 35 ILCS 173/5-50(3).