**IRS Eases Slightly In Dispute Over Derivatives Tax**

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WASHINGTON (Dow Jones)--The U.S. Internal Revenue Service has eased its position on the tax treatment of hedging transactions that a company failed to identify as a hedge.

In a reversal of a previous position, the IRS will consider a firm's claim that its failure to identify a derivative contract as a hedge was due to "inadvertent error," according to an internal email released by the tax agency last week.

The decision, which affects only exchange-traded derivatives, opens the door a crack for taxpayers to contest the tax treatment of some transactions. But the IRS signaled it will continue to cast a skeptical eye on attempts by firms to designate transactions as hedges after the fact.

"The IRS has recently been taking a hard line on taxpayers who fail to identify their hedges and then later claim hedge treatment," said Viva Hammer, a tax lawyer and former Treasury Department official responsible for regulations governing derivatives transactions.

The question of whether a transaction is treated as a hedge or not for tax purposes could mean millions for a firm's tax liability. A loss on a hedging contract is treated as an ordinary loss, which a firm can use to lower its taxable income.

But if a contract is not designated as a hedge, the tax code treats it as capital income or loss, which cannot be used to offset ordinary income.

Further, changes included in the recent Dodd-Frank financial overhaul legislation will focus more attention on tax issues surrounding derivatives, Hammer said.

"This ruling will have far greater implications because of Dodd-Frank, as many more derivatives will now be traded on exchanges," she said.

Corporations of all kinds use commodity and currency derivatives to hedge against risk from fluctuations in the exchange rate, energy prices, and other risks.

In general, the tax code requires that taxpayers identify hedging transactions up front in order to qualify for treatment as ordinary gains or losses. This is partly to prevent gaming, where a firm could decide after the fact how to designate a transaction. For instance, a firm might prefer to take a capital gain on a transaction in order to soak up capital losses elsewhere in its portfolio.

The exception for inadvertent errors should not be viewed as "an open-ended invitation for taxpayers to brush aside establishing hedge identification procedures," according to the IRS email advice.

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