

## SUMMARY

QUESTION: Are gross receipts or net receipts from commodity hedging transactions excluded or included in the sales factor of the apportionment formula?

ANSWER: Generally speaking, both gross receipts and net receipts from commodity hedging transactions are excluded from the sales factor since such transactions are not "true sales." However, if a taxpayer sells that specific commodity as a regular part of its profit-making business activities, the net gains associated with those particular hedging activities are included in the sales factor so long as the taxpayer treats those activities as a profit-making activity on its books and records.

May 25, 2012

XXX  
XXX  
XXX

Re: Technical Assistance Advise ment 12C1-007  
Corporate Income Tax Sales Factor  
XXX ("the Taxpayer")

Dear :

This letter is in response to your letter of January 27, 2012, which requests a ruling regarding the proper treatment by XXX ("Parent") and Subsidiaries (together, the "Group") of certain receipts from commodity derivative transactions in determining its Florida sales factor. This response constitutes a Technical Assistance Advise ment ("TAA") under Chapter 12-11, Florida Administrative Code ("F.A.C."), and is issued to you under the authority of Section 213.22, Florida Statutes ("F.S.").

### FACTS PROVIDED BY THE TAXPAYER

Parent is the parent corporation of a federal affiliated group. The Group's business includes both selling generated power into an unregulated market and a regulated electric utility (which is the main operating entity). The Group files a Florida consolidated corporate income tax return in which the group members mirror Parent's federal consolidated group.

Taxpayer is a Delaware limited liability company [wholly-owned by Parent] and Taxpayer is treated as an entity disregarded from its owner for federal income tax purposes. Taxpayer conducts business in several states as the trading and marketing company for certain affiliates of Parent. Taxpayer's primary roles include:

- (1) selling tangible personal property, specifically electricity, produced by unregulated affiliates of the Group;
- (2) procuring certain commodities, primarily natural gas and oil, used in the Group's power generating process; and
- (3) managing the risk of price fluctuations in the commodity markets for the Group.

Taxpayer primarily uses financially-settled derivative instruments such as swaps, options, and futures contracts to lock in, or "hedge," pricing in order to manage the commodity price risk exposure inherent in the Group's business. Taxpayer employs people both within and without Florida to engage in the trading of derivatives. Taxpayer's hedging activities help protect the members of the Group from commercial risks that include:

- (1) protection of the price at which the members of the Group can sell electricity; and
- (2) consistency in the price at which members of the Group purchase their commodity inputs.

Parent owns various power generation plants, many of which do not enter into long-term sales contracts for the sale of their electric output. As a result, the future sales price of the electricity that will be produced by these plants is subject to price fluctuations in the wholesale commodity markets. In order to effectively manage the price risk associated with the output of these plants, Taxpayer implements a hedging strategy to hedge the sale price of each plant's future sale of electricity; each hedging strategy will generally use a vast number of derivative contracts to achieve the desired goal. Parent regularly evaluates its hedging strategy for each plant and determines the price it wants to receive from the future sales of electricity generated by those plants. The derivative transactions related to the future sales price of Parent's energy are referred to as "output hedges."

Similarly, when Parent determines how much natural gas or other commodities are required to produce its electricity in the future, Taxpayer implements a hedging strategy to lock in the desired cost of the goods used in the production of electricity that Parent will sell. The derivative transactions related to hedging the future purchase price of the cost of goods sold are referred to as "input hedges."

As noted above, Taxpayer's primary objective with its hedging transactions is not to make a profit, but to maintain as close to a neutral position as possible between its cash commodities position and its financial commodities position in order to hedge against the risk of price fluctuations inherent in the commodities cash market. The majority of Taxpayer's trading activities in the commodity derivatives market are triggered by planned or actual purchases of commodities in the cash market. Parent's books and records reflect the hedging activity in a manner consistent with their purpose and Parent's operations. Specifically, the gains and losses from each hedge are recorded on the books and records of the power plant for which the hedge is used. For both tax and financial accounting purposes, Parent reports the gains and losses from hedging activities based on

the purpose of each hedge. In accordance with Generally Accepted Accounting Principles ("GAAP"), any gain or loss realized on a derivative transaction related to managing exposure to market fluctuations in the price for input commodities (e.g., oil or natural gas) is treated as a component of cost of goods sold.<sup>1</sup>

Conversely, any gains or losses realized on the derivative transactions which hedge the sales price of output commodities (e.g. the electricity sold) are treated as income from operations.<sup>2</sup> This treatment ensures that the financial statements accurately reflect Parent's true sales and/or business done as well as the true cost of goods sold.

Finally, Taxpayer may participate in financially-settled derivative transactions for which there is no underlying commodity market price risk that must be hedged (hereinafter "proprietary trading"). Taxpayer engages in proprietary trading for a number of reasons: one significant reason is to keep Taxpayer's traders active in the markets where it needs to hedge the price risk of commodities. This activity is necessary because the price of electricity is volatile and varies greatly between markets. Since Parent will engage in electricity deals in every market over time, the proprietary trading ensures that Taxpayer's traders are knowledgeable in every market and can respond quickly to Parent's hedging needs. Parent has established very narrow risk margins for Taxpayer and strictly monitors the proprietary trades in order to limit its exposure related to this activity. The net gains and losses attributable to proprietary trading are included as a component of revenue.

### **ISSUES PRESENTED**

1. Whether or not the gross receipts from the hedging transactions entered into by Taxpayer are included in the sales factor of the apportionment formula.
2. Whether or not the net gains and losses from the hedging transactions entered into by Taxpayer are included in the sales factor of the apportionment formula.

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<sup>1</sup> See, ASC 815-25-50, *Derivatives and Hedging – Fair Value Hedges*, which provides that changes in the fair value of derivative instruments designated as fair value hedges, as well as the offsetting changes in fair value of the hedged items, should be recognized in earnings in the same accounting period. ASC 815 does not specify the income statement line item presentation of changes in fair value of derivative instruments designated as hedges. Over time, an industry practice of reflecting the changes in fair value of derivative instruments in the same financial statement line item as that of the hedged item has developed.

<sup>2</sup> See, Treas. Reg. s. 1.446-4(b), which provides that "the method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the time of income, deduction, gain, or loss from the item(s) being hedged."

## DISCUSSION AND ANALYSIS

Speaking very generally, the calculation of the Florida corporate income tax starts with a corporation's federal taxable income. After certain addbacks and subtractions to federal taxable income required by Chapter 220, F.S., the amount of adjusted federal income attributable to Florida is determined by the application of an apportionment formula. The Florida corporate income tax uses a three-factor apportionment formula consisting of property, payroll, and sales (which is double-weighted) to measure the portion of a multistate corporation's business activities that is attributable to Florida. Income that is attributable to Florida using the applicable apportionment formula is then subject to the Florida corporate income tax.<sup>3</sup>

### Gross Receipts from hedging transactions.

Section 220.15(5), F.S., provides that the "sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year or period, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year or period."<sup>4</sup> Generally speaking, the sales factor should reflect the value of the markets for a taxpayer's goods and services since its purpose is to balance the property and payroll factors by giving weight to elements of the business not reflected in those factors. See generally, *Altman and Keesling, Allocation of Income in State Income* (2d Ed. 1950). It is generally accepted that the sales factor represents the contribution of the market to the profits of the corporation.

The concept of apportionment is distinguishable from taxability. Apportionment is a measure of business activity. A state may fairly apportion income as long as its taxing scheme meets the requirements of the Due Process Clause, and the "income attributed to the state for tax purposes must be rationally related to values connected with the taxing state." *Miller Bros. Co. v. Maryland*, 347 U.S. 340, 344-345 (1954); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

The significance of the term "sales" for purposes of calculating the apportionment factor has been recognized by the Florida courts in *Department of Revenue v. Anheuser-Busch*, 527 So.2d 877 (Fla. 1<sup>st</sup> DCA 1988) and *Coulter Electronics v. Department of Revenue*, 365 So.2d 806 (Fla. 1<sup>st</sup> DCA 1978). Under Florida law, the purpose of the

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<sup>3</sup> In the event that the standard apportionment formula does not fairly represent the tax base, a taxpayer may apply for relief under Section 220.152, F.S. Likewise, the Department may require a taxpayer to use an alternative apportionment method if the standard apportionment formula does not fairly represent the tax base.

<sup>4</sup> Section 220.15(5), F.S., goes on to provide: "As used in this subsection, the term 'sales' means all gross receipts of the taxpayer, except interest, dividends, rents, royalties, and gross receipts from the sale, exchange, maturity, redemption, or other disposition of securities. (Emphasis added). Although the term "securities" is not defined in Chapter 220, F.S., its use in the context of apportionment suggests that the narrow definition found in the laws governing securities regulation is not applicable and that the broader dictionary definition should be used. However, the application of Section 220.15(5), F.S., to hedging transactions is not necessary to the resolution of this issue, and it will not be addressed at this time.

apportionment formula is to correctly measure a taxpayer's business activities within the State of Florida. As the Appellate Court noted in *Anheuser-Busch* (quoting *A. England, Income Taxation in Florida: Background, Scope, and Analysis, F.S.U. Law Review* 1972),

The purpose of Florida's apportionment statute is to apportion a part of a multi-state taxpayer's total income from all sources to the State of Florida based upon the taxpayer's Florida business activities.

Rule 12C-1.0155(1), F.A.C., states that for purposes of the sales factor of the apportionment formula, the term "sales" means all gross receipts received by the taxpayer from transactions and activities in the regular course of its trade or business. (Emphasis added). The Florida courts have held that the sales factor cannot be artificially increased or decreased by the inclusion or exclusion of transactions that are not true sales. To do so would defeat the intent of the Florida Legislature to tax the income of a multi-state corporation that is derived from its business activities within and without Florida. *Coulter Electronics v. Department of Revenue, supra*. See also, *Tropicana Products v. Department of Revenue, Case No. CA-74-1799, 12<sup>th</sup> Judicial Circuit in and for Manatee County, Florida, aff'd per curiam, 353 So.2d 686 (Fla. 2d DCA 1977)* (holding that transactions between the taxpayer and its wholly-owned subsidiaries should be excluded from the apportionment formula). In *Coulter*, the sales factor was adjusted to exclude certain intercompany transactions between related companies on the basis that those transactions were not actual sales for purposes of the apportionment formula. In *Anheuser-Busch*, the Appeals Court held that intercompany sales should be included in the apportionment formula in order to accurately reflect Anheuser-Busch's business activities in Florida.<sup>5</sup> These sales were included (and excluded) by the *Coulter* and *Anheuser-Busch* courts on the basis that they were not "true sales." Taxpayer's hedging transactions are not "sales" and do not represent or reflect the Group's business. Including such transactions would not fairly represent the Group's business in Florida, and for these reasons, the gross receipts from the hedging transactions would be excluded from the sales factor of the apportionment formula. *Department of Revenue v. Anheuser-Busch, supra; Coulter Electronics v. Department of Revenue, supra*. Accordingly, Taxpayer's gross receipts from hedging activities are excluded from the sales apportionment factor because they do not constitute "sales" as that term is used in Section 220.15(5), F.S.

In addition, for financial reporting purposes, the gross receipts from hedging transactions are not reported as "sales" or as "gross receipts" because they do not represent true sales, and to report them as such would misrepresent the financial condition of a company. If a company was allowed to report hedging transactions as sales, it could easily manipulate

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<sup>5</sup> Florida does not have to invoke its powers under Section 220.152, F.S. (alternative apportionment), or Section 220.44, F.S. (general equitable powers), to exclude or include certain sales in the sales factor of the apportionment formula. See, *Coulter, supra*, and *Anheuser-Busch, supra*. But see *General Mills v. Franchise Tax Board, 172 Cal. App. 4<sup>th</sup> 1535 (Cal. App. Ct. 2009)* (hedging transactions were "gross receipts" for purposes of California's apportionment statute).

sales figures for financial reporting purposes or for tax purposes by repeatedly buying and selling matching option or futures contracts without incurring any real economic consequences. Taxpayer has advised that for financial accounting purposes, it does not report its hedging transactions as "sales" or as "gross receipts" and that this treatment is in accordance with Generally Accepted Accounting Principles ("GAAP"). Although there are significant differences between income tax accounting and GAAP, income tax accounting is derived from GAAP and follows many of its principles. Neither Taxpayer nor the Group reports the gross receipts from the hedging transactions as sales on their federal tax returns or their financial statements. As previously mentioned, the Florida courts have recognized that the accounting treatment of a transaction is an element that may be considered in determining whether the income associated with such a transaction should be apportioned. *Department of Revenue v. Anheuser-Busch, supra*. Accordingly, Taxpayer's gross receipts from hedging activities are excluded from the sales apportionment factor since those activities are not sales, as that term is used in Section 220.15(5), F.S., but are instead a cost of goods sold.

Net income from hedging transactions.

Taxpayer suggests that the net income (but not the gross receipts) from the hedging transactions should be included in the sales factor of the apportionment formula. Taxpayer's use of hedging transactions differs from those taxpayers who engage in speculative commodity trades. Unlike speculative traders, Taxpayer engages in commodity trades in order to hedge its supply of commodities or ensure a market for its electricity, and that is its primary purpose. Taxpayer does not expect to realize a profit and, in fact, it does not time or organize its trades to make a profit. However, consistent with standard hedging practices, Taxpayer offsets almost all of its original hedging contracts rather than letting them result in actual delivery of the commodity. The number of actual hedging instrument trades completed by Taxpayer is voluminous while, generally, the net income or loss from the trades is comparably small. For example, in one month, Taxpayer entered into approximately \$60 million in hedging contracts, but realized a little less than \$200,000 in profits on those contracts, or a profit of less than one-third of one percent. As the U.S. Supreme Court noted with respect to a manufacturer in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), "hedging transactions . . . [are] essentially insurance, rather than income from dealing in capital assets . . ." <sup>6</sup> There are significant qualitative differences between the Group's business, which is generating and selling electricity, and its hedging activities, which, although integral to the Group's business, serve in a support function. It would appear that Taxpayer realizes offsetting losses in other months, and that based on its salary costs, hedging is rarely a profitable activity.

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<sup>6</sup> Although Taxpayer does not seek to make a profit on hedging alone, hedging transactions are made for the ultimate purpose of making a profit on the Group's business activities. As the U.S. Supreme Court noted in *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), "it is difficult to imagine a program more closely geared to a company's manufacturing enterprise or more important to its successful operation."

Taxpayer primarily engages in two types of hedging transactions, those intended to secure a supply of oil and gas used to generate electricity ("input hedges") and those intended to ensure a market for its electricity ("output hedges"). A third type, which is intended to provide Taxpayer with market information on the sale of electricity ("proprietary trading"), is conducted on a very limited basis. Taxpayer's hedging activities also differ from the hedging activities of other manufacturers. Taxpayer is a regulated monopoly whose rates, costs, and to some extent, profits, is controlled by state public utility commissions. And, unlike most manufacturers who hedge just their supply sources (raw materials), Taxpayer also engages in hedging in the market for electricity, where it sells its excess capacity. Input hedges that are used to secure a supply of raw materials are a form of insurance and, in that sense, are reflected in the cost of goods sold by Taxpayer. Like insurance, input hedging transactions reduce the risk of price fluctuations, and like insurance, input hedging securities are purchased as protection, and not for the purpose of making a profit. Output hedges differ from input hedges in the sense that they are intended to secure a steady price for the electricity generated by the Group. In a sense, output hedges are insurance that the Group will be able to supply its customers with electricity. In another sense, output hedges (and proprietary trades) are transactions that support the Group's primary business of selling electricity and realizing a profit from doing so. Taxpayer treats the gains and losses from input hedges as a cost of goods sold on its books and records, but treats the net income from its proprietary trades and output hedges as part of the sale of electricity.

Taxpayer is a regulated monopoly whose primary business is the sale of electricity. It treats the proceeds from its input hedges (used to insure against price fluctuations of raw materials) as a cost of goods sold. Taxpayer engages in input hedge transactions for the purpose of securing a supply of raw materials and to protect against price fluctuations, rather than to make a profit. Under *Department of Revenue v. Anheuser-Busch*, 527 So.2d 877 (Fla. 1<sup>st</sup> DCA 1988) and *Coulter Electronics v. Department of Revenue*, 365 So.2d 806 (Fla. 1<sup>st</sup> DCA 1978), the net receipts from input hedging transaction are excluded from the sales factor of the apportionment formula, even though some of those sales occur in Florida. Such sales are excluded since they are not "sales" as that term is used in Section 220.15(5), F.S.

The net receipts from the output hedging transactions present a more difficult issue. Logically, if the gross receipts from the output hedging transactions are excluded from the apportionment factor as not "sales," then the net receipts should likewise be excluded. Unlike the gross receipts from output hedging transactions, the net receipts from output hedging transactions are reflected and are part of the actual sale of electricity by Taxpayer. Taxpayer is in the business of selling electricity and it sells its excess electricity on the open market. In this specific instance, it is clear that the net receipts from the hedging transactions are incorporated into the actual sale of electricity, and Taxpayer treats the net receipts from its output hedges as a "sale" on its books and records and attributes or sources the output hedges to the specific power plant for which the sale was made. For these reasons, under *Department of Revenue v. Anheuser-Busch*, 527 So.2d 877 (Fla. 1<sup>st</sup> DCA 1988) and *Coulter Electronics v. Department of Revenue*,

*365 So.2d 806 (Fla. 1<sup>st</sup> DCA 1978)*, the net receipts from output hedging transaction are included in the sales factor of the apportionment formula and attributed to the specific power plant to which the sale pertains.

The remaining issue is the treatment of net receipts from proprietary trading, where Taxpayer makes market trades in order to determine the spot price of electricity and trends in the electricity market. Taxpayer engages in a limited number of trades and either realizes a loss or very small gains on these proprietary trades. The amount of net receipts is minimal. Taxpayer treats the net gains from these trades as revenue on its books and records, but does not attribute them to a particular power plant. Although the accounting treatment of a receipt is part of the determination of whether or not an item of income is a "sale," it is not the only factor. The focus of both *Anheuser-Busch* and *Coulter Electronics* was whether or not there was a "true sale." Hedging activities that are undertaken to measure the market are more in the nature of an expense. The fact that such activities may occasionally result in income, rather than loss, does not change that underlying sense. Taxpayer undertakes proprietary trading as a support function in order to determine market trends and pricing, and can best be analogized to a market research activity. Accordingly, the net receipts realized by Taxpayer from proprietary trading would be excluded from the sales factor of the apportionment formula.

### CONCLUSION

For the reasons stated above, the gross receipts from hedging transactions are excluded from the sales factor of the apportionment formula. The net income from hedges used to secure a source of supply and from hedges used to determine market price are excluded from the sales factor, while the net income from hedges used to sell electricity are included in the sales factor.

This response constitutes a Technical Assistance Advisement under s. 213.22, F.S., which is binding on the Department only under the facts and circumstances described in the request for this advice, as specified in s. 213.22. Our response is predicated on those facts and the specific situation summarized above. You are advised that subsequent statutory or administrative rule changes or judicial interpretation of the statutes or rules upon which this advice is based may subject similar future transactions to a different treatment from that which is expressed in this response.

You are further advised that this response, your request and related backup are public records under Chapter 119, F.S., and are subject to disclosure to the public under the conditions of s. 213.22, F.S. Confidential information must be deleted before public disclosure. In an effort to protect confidentiality, we request you provide the undersigned with an edited copy of your request Technical Assistance Advisement, the backup material and this response, deleting names, addresses and any other details which might lead to identification of the taxpayer. Your response should be received by the Department within 15 days of the date of this letter.



Sincerely,

Gary A. Moreland  
Senior Attorney  
Technical Assistance and Dispute Resolution

Record ID: 118295