pennsylvania
DEPARTMENT OF REVENUE

CORPORATION TAX BULLETIN 2019-01

ISSUED: January 4, 2019
EFFECTIVE: Taxable years beginning after December 31, 2018

CORPORATE NET INCOME TAX
HEDGING AND FOREIGN CURRENCY TRANSACTIONS

The corporate net income tax is imposed under Article IV of the Tax Reform Code (TRC). 72 P.S. §§7401 et seq. The purpose of the sales factor in TRC Section 401(3)2.(a)(1)(E) is to apportion the business income of a taxpayer conducting an interstate business to this State based on this State's relative share of the marketplace for the goods and services sold by the taxpayer to its customers in the course of its business.

Hedging transactions are entered into by taxpayers primarily to manage interest rate risk or the risk of price or currency fluctuations.

Federal income tax law provides a framework for identifying gains and losses from hedging transactions to the transactions or class of transactions being hedged and for keeping records necessary to support the identifications. The federal practice for identifying hedging transactions should be followed for Pennsylvania purposes.

General Rule

Receipts from hedging transactions are excluded from the numerator and denominator of a taxpayer's Pennsylvania Corporate Net Income Tax Apportionment fraction.

The receipts to which the General Rule applies include:

1. Gross receipts related to gain or loss from a transaction identified as a hedge under 26 USC 1221(b)(2)(A)[i] or 475(c)(3)[ii];
2. Receipts attributed to accrued interest income or expense, gain or loss on a debt instrument, a payable, a receivable or a forward contract payable in a foreign currency for foreign currency gain or loss that is computed under 26 USC 988;
3. Gross receipts related to 26 USC 986(c)(1) foreign exchange gain or loss on distributions of previously taxed income.

Analysis

IRC section 475(c)(3) defines a "hedge" as "any position which manages the dealer's risk of interest rate or price changes or currency fluctuations, including any position which is reasonably expected to become a hedge within 60 days after the acquisition of the position." Section 1221(b)(2)(A) similarly defines a hedging transaction to mean any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business. It stipulates that the transaction should be to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer, or with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred by the taxpayer, or to manage such other risks as prescribed in regulation.

In TRC Section 401(3)2.(a)(1)(E), "Sales" means all gross receipts of the taxpayer not allocated under this definition other than dividends received, interest on United States, state or political subdivision obligations and **gross receipts heretofore or hereafter received from the sale, redemption, maturity or exchange of securities,** except those held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business (emphasis added).

Therefore, gross receipts, gains and/or losses on hedging transactions entered into to manage the risks associated with the acquisition of resources by a taxpayer as defined in 26 USC 1221(b)(2)(A) or 475(c)(3) shall be excluded from both the numerator and denominator of the sales factor. Also, gross receipts relating to foreign currency transactions that are computed under 26 USC 988 with respect to accrued interest income or expense, gain or loss on a debt instrument, a payable, a receivable or a forward contract payable in a foreign currency described in 26 CFR 1.988-1(a)(2), and gross receipts related to foreign currency gain or loss recognized pursuant to 26 USC 986(c)(1) on distributions of amounts previously taxed to the recipient as subpart F income or as earnings of a qualified electing fund shall all be excluded from both the numerator and denominator of the sales factor. These transactions do not reflect the market for the taxpayer's goods and services and are similar in nature to securities and are not held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Therefore, these transactions should be excluded from the sales factor altogether.

This bulletin is effective for taxable years beginning after December 31, 2018.
Please visit the Department's website www.revenue.pa.gov.

---

[i] IRC § 1221(b)(2)(A) addresses hedging transactions in the context of capital assets.
[ii] IRC § 475(c)(3) addresses hedging transactions in the context of dealers in securities.