

2001

# Concerto For Piano vs. Orchestra: Can Tax and Financial Accounting Harmonize on Hedges?

John J. Ensminger

Please take a moment to share how this work helps you [through this survey](#). Your feedback will be important as we plan further development of our repository.

Follow this and additional works at: <https://ideaexchange.uakron.edu/akrontaxjournal>

Part of the [Tax Law Commons](#)

---

## Recommended Citation

Ensminger, John J. (2001) "Concerto For Piano vs. Orchestra: Can Tax and Financial Accounting Harmonize on Hedges?," *Akron Tax Journal*: Vol. 16 , Article 2.

Available at: <https://ideaexchange.uakron.edu/akrontaxjournal/vol16/iss1/2>

This Article is brought to you for free and open access by Akron Law Journals at IdeaExchange@UAkron, the institutional repository of The University of Akron in Akron, Ohio, USA. It has been accepted for inclusion in Akron Tax Journal by an authorized administrator of IdeaExchange@UAkron. For more information, please contact [mjon@uakron.edu](mailto:mjon@uakron.edu), [uapress@uakron.edu](mailto:uapress@uakron.edu).

## CONCERTO FOR PIANO VS. ORCHESTRA: CAN TAX AND FINANCIAL ACCOUNTING HARMONIZE ON HEDGES?

by

John J. Ensminger\*

The preference for fair value accounting, for marking items to market for financial reporting or tax purposes, has been particularly strong in the last decade, and has become almost doctrine among accounting standards setters as the preferred method of accounting for financial instruments. Though a similar trend can be documented for tax accounting, the longstanding preference for correlating tax liability with realization events continues to prevent consistency.<sup>1</sup> Also preventing consistency are the myriad difficulties in distinguishing capital gain from ordinary income (where embedded derivatives seem to make the result almost arbitrary), those equally subtle difficulties in distinguishing debt from equity (where derivatives appear often to be neither or both), and, particularly recently, the differences between tax systems of different countries in which transactions are made to occur (with some countries still struggling to educate tax officials about derivatives). These inconsistencies, which in the fertile imaginations of tax lawyers become tax shelters, would largely disappear if fair value accounting were universal in the tax law. One could argue for a sort of global marking to market on December 31—a single calendar year for all taxpayers would also be helpful—with all countries

---

\* President, Delta Hedge Publications. The author wishes to thank Ira Kawaller, President, Kawaller & Co., a member of the Derivatives Implementation Group, and Robert E. Jensen, Jesse H. Jones Distinguished Professor of Business Administration, Trinity University, for numerous helpful suggestions that considerably improved this article. This article was completed before the enactment of the Commodity Futures Act of 2000 (H.R. 5660) and the Community Renewal Tax Relief Act of 2000 (H.R. 5662), both enacted on December 21, 2000 as parts of Pub. Law No. 106-554, which would affect some comments made herein.

<sup>1</sup> Accrual accounting, as used in the original issue discount (OID) regulations, based on a yield curve that is not changed during the life of the transaction, does not reflect, absent a disposition, changes in market or credit risk. With the limited flexibility of such fixed income calculations, this kind of system only approximates a mark-to-market method. “[T]he contingent payment debt formula is an attempt to come close to bifurcation with a set of rules that is simpler to apply.” David A. Weisbach, *Tax Responses to Financial Contract Innovation*, 50 TAX L. REV. 491, 518 (1995). To Professor Weisbach, bifurcation “promises simplicity because it taxes hybrids based on the taxation of components . . . .” *Id.* at 507.

agreeing to tax the difference from the year before at 28 percent, allocating the result between themselves under some universally applied transfer pricing formula. Assuming that this approach is politically impossible in every country, and that even if a few countries agreed to it, others would not, one can still validly ask whether the advances that have recently been made in financial accounting hold any lessons for tax accounting. To be somewhat more limited, can the Statement of Financial Accounting Standard No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*, provide any guidance for Congress as to some appropriate alterations of the U.S. tax system? It will be the purpose of this paper to review the deferral system provided by the hedge accounting allowed by SFAS 133, and to compare this system against those tax deferrals that can be obtained under the U.S. tax system.

### I. HOW WOULD A TAX SYSTEM BASED ON SFAS 133 WORK?

The tax system has more often preferred to integrate transactions,<sup>2</sup> on the assumption that the true nature of the taxpayer's activities will be more apparent if those activities are viewed collectively. The financial accounting system has, particularly with SFAS 133, preferred bifurcation on the general assumption that this is a more efficient approach for obtaining accurate valuations.<sup>3</sup> The tax system began as a realization system, but has, with fits and starts, adopted some mark-to-market approaches.<sup>4</sup>

---

<sup>2</sup> A complete integration system would combine a taxpayer's entire portfolio into a single position to provide a tax treatment for that position. Deborah H. Schenk, *Taxation of Equity Derivatives: A Partial Integration Proposal*, 50 TAX L. REV. 571, 579 (1995). Integration can also be applied to sets of instruments that are combined for purposes of applying a tax regime, which, as indicated in the following discussion, is an approach that has found considerable popularity in the United States tax system.

<sup>3</sup> For an example where Statement of Financial Accounting Standard [hereinafter, SFAS] No. 133 may require integration, see note 51, *infra*. Bifurcation as a basic approach to the tax law has its proponents. See Weisbach, *supra* note 1; Reed Shuldiner, *A General Approach to the Taxation of Financial Instruments*, 71 TEX. L. REV. 243 (1992).

<sup>4</sup> It might be more accurate to say that Congress has reluctantly realized that modification of the realization system is necessary for some degree of equity, and the complexity of such concessions may actually be making adoption of a mark-to-market system more difficult. Modifications or the realization system include the capital/ordinary distinction (whether an asset is sold vs. income from the asset), holding period rules (difference between investment and business assets), cost recovery conventions (business assets need not wait for final disposition to provide some tax benefit), capitalization rules (some current deductions

SFAS 133 moves derivatives onto a mark-to-market system, and when a derivative qualifies as a hedge under the Statement, the item hedged will, as to the risk being hedged, be marked to market as well.<sup>5</sup> Beyond derivatives, the Financial Accounting Standards Board (the FASB) has begun a process that will likely lead to a Standard requiring that all financial instruments be reported at fair value.<sup>6</sup>

One could pose the question of comparing the tax and financial accounting systems several ways. Should the tax system bow to the more successful efforts of the FASB to adopt a mark-to-market approach? Should the two approaches be forced to attempt reconciliation where possible? Should the two systems, with their different objectives, be irrelevant to each other? The latter makes this paper an exercise in futility. The second is probably a more intelligent question, but allows for too many variations for an efficient debate. This article, therefore, will look at the matter in the first way, focusing largely on the question of how hedging transactions would be taxed if the tax system had to pattern itself as closely as possible to the financial accounting system. The question is simply: if the tax law were built on SFAS 133, would this be a workable system? Would it be a good system? The answers that will be given here are, yes, and, with some caveats about implementation, yes. Would it be a better system than

---

should be added to the tax attributes that will be recognized on disposition), wash sale rules (sale and re-acquisition should not be recognized as a full sale), and the straddle rules (combinations of assets can disguise disposition strategies).

<sup>5</sup> Special hedge accounting may defer gains and losses from such fair value adjustments in other comprehensive income, as discussed further *infra*.

<sup>6</sup> *Preliminary Views*, Financial Accounting Series No. 204-B (December 14, 1999) <<http://www.rutgers.edu/Accounting/raw/fasb>> [hereinafter *Preliminary Views*]. On October 24, 2000, in a Project Update on its website, the FASB indicated the current status of the "fair value" project:

Currently representatives of the Board and staff are participating in a Joint Working Group of Standard Setters that is developing a paper on accounting for financial instruments that is much broader in scope than the Preliminary Views. The JWG plans to complete its paper before the end of 2000, and the Board and the other participating standard setters expect to issue it and request comments. The Board will not deliberate the individual decisions in the paper, which differs in many respects from both existing GAAP and the proposals in the recent Preliminary Views. Consequently, the paper will be issued as Invitation to Comment, a Special Report, or a similar document rather than as an Exposure Draft.

the current one? Probably, but not without importing some of the wisdom from the current tax structure.

The major changes that would result if the tax treatment of hedges were to follow that used in financial accounting—including the recent proposals to mark all financial instruments to market—are the following:

1. All derivatives would be marked to market, as exchange-traded derivatives already are, and generally treated consistently.
2. Hedging would generally require an offset as to an identifiable transaction or set of transactions.
3. Marking to market would be presumed to provide a clear reflection of income in tax accounting.
4. Derivatives would be a general category including many financial instruments now treated separately, and the definition would be sufficiently broad so as to include most instruments used for hedging.
5. Hedged items would generally be, at least as to the risks being hedged, marked to market along with the hedging instruments during the duration of the hedge.
6. Overall risk reduction would not be a requirement. (As of this writing, Section 1221(b)(2) defines hedging as a mechanism for risk management, not risk reduction. Exactly how this will change the regulatory structure, which generally seeks overall risk reduction for a hedging transaction, remains to be seen.)
7. Anticipated transactions would have to be probable to be hedged.
8. Hedging the cash flows of anticipated transactions could allow for some deferral (depending on how one integrates the SFAS 133 concept of “other comprehensive income” into the tax system).
9. Derivatives embedded in debt instruments (such as in contingent payment debt instruments) would generally be separated from the host debt instrument and accounted for separately. If more than one derivative were embedded in the host, the derivatives would be extracted as a unit and accounted for as a unit, not as two or more separate free-standing derivatives. Thus, the original issue discount system of Treasury Regulation 1.1275-6 allowing for integrating a hedge and a debt instrument would no longer be available.
10. Derivatives separated from a host instrument could hedge transactions other than the host. (In the tax law, with contingent payment hedges, embedded derivatives need not hedge the host, but do affect the cash flows of the hybrid instrument.)

11. Hedging would be permitted for capital assets. Thus, straddles and conversion transactions where one leg is a derivative could be treated as hedging arrangements.

A tax system would require some elements not found in SFAS 133. Absent a very broad mark-to-market system, there would have to be some ability on the part of the IRS to impose hedge accounting, or it would be possible to have economic hedges without designation of the two transactions as correlated under the hedge accounting system. This could provide arbitrage as to the cash flow associated with a nonderivative side of a hedge, which might be carried at historical cost (or some other non-fair value measure).

To understand more precisely how an SFAS 133 tax system would work, a more detailed comparison is required and will be attempted here as to the hedging system of SFAS 133, and collaterally as to the system of treating embedded derivatives under that Statement. The hedging system of SFAS 133 requires that a hedge be highly effective in order for the hedging relationship to be recognized.<sup>7</sup> Only those relationships that qualify as fair value, cash flow or foreign currency hedges are entitled to such deferral. The U.S. tax system is far less consistent. In addition to those provisions that deal with the timing, character, and currency aspects of hedging, one must also consider—at least for purposes of determining how SFAS 133 could provide modeling ideas for the tax system—those deferrals that are brought about by the straddle and conversion rules.

## II. WHAT IS A HEDGING TRANSACTION?

End-of-1999 tax legislation<sup>8</sup> contained a modification of the definition of hedging for federal income tax purposes. Previously contained in Section 1256(e)(2), and at Treasury Regulation 1.1221-2(b), the revision now puts it where it more properly belongs, in Section 1221, making hedging clearly an exception to the presumption of capital treatment. Section 1256(e), which previously provided the definition in the Code, now relies a cross-reference to Section 1221(b)(2)(A) to explain what a hedging transaction is. A hedging transaction is defined in Section 1221(b)(2)(A) as:

---

<sup>7</sup> See Financial Accounting Standards Board, *Derivatives Implementation Group* Issue No. E 11 (Feb. 17, 1999). It concludes that even if a hedged item has a limited risk exposure, an instrument without the same limits to its risk exposure may be designated as a hedging instrument if the entity can establish that the hedging relationship is expected to be highly effective.

<sup>8</sup> Tax Relief Extension Act of 1999, part of the Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, n3 Stat. 1860.

[A]ny transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily –

- (i) to manage risk of price changes or currency fluctuations with respect to ordinary property<sup>9</sup> which is held or to be held by the taxpayer,<sup>10</sup>
- (ii) to 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, or
- (iii) to manage such other risks as the Secretary may prescribe in regulations.

The most important change in the new wording of the hedging exception to capital treatment is the concept that a hedging transaction *manages* risk. Section 1256(e)(2) had defined hedging as an activity that *reduced* risk and risk reduction had been a requirement in the prior regulatory structure.

A transaction is entered into in the normal course of a trade or business if it is entered into "in furtherance of a taxpayer's trade or business."<sup>11</sup> Not all ordinary property can be the subject of a hedge under Treasury Regulation 1.1221-2:

[T]he regulations do not apply where a taxpayer hedges a dividend stream, the overall profitability of a business unit, or other business risks that do not relate directly to interest rate or price changes or currency fluctuations.<sup>12</sup>

---

<sup>9</sup> A de minimis amount of the risk being hedged can arise from non-ordinary property. Treas. Reg. § 1.1221-2(c)(7) (2000). The ordinary property need not produce ordinary income. In Private Letter Ruling 98-24-026, swaps were hedging transactions as to ordinary property that gave rise to tax-exempt income. Priv. Ltr. Rul. 98-24-026 (Mar. 12, 1998). The Ruling cites Treasury Regulation § 1.512(b)-1(a)(1) (2000), under which income from notional principal contracts (as defined in Treasury Regulation § 1.863.7 or regulations issued under Section 446) is analogized to ordinary income payments like dividends, interest, and annuities, which is excluded from the calculation of unrelated business income.

<sup>10</sup> In Technical Advice Memorandum 97-20-003, the business of an S corporation dairy farm was not that of a shareholder who held futures in commodities going into dairy feed as an offset against price increases in the feed. Tech. Adv. Mem. 97-20-003 (Jan. 15, 1997). The National Office concluded that hedge accounting was not available because the taxpayer could not attribute the business of his S corporation to himself. Members of a consolidated group can treat transactions of each other as hedges, or not, under Treasury Regulation § 1.1221-2(d) (2000).

<sup>11</sup> Treas. Reg. § 1.1221-2(c)(4) (2000).

The ordinary treatment restriction makes tax hedge accounting narrower than financial hedge accounting, since financial hedge accounting can apply to transactions that are capital from a tax perspective.

*Example One.* Delrey Corp. holds an investment of 10,000 shares of Xynon stock, and purchases a put option on 20,000 shares with a strike price equal to the current price of the stock.<sup>13</sup> The put hedges Delrey's exposure to changes in the fair value of the Xynon stock. Because the stock is not ordinary property as to Delrey, this is not a hedge for tax purposes. It is likely to be a straddle, however.<sup>14</sup>

For tax purposes, there is no requirement that the hedging instrument be a derivative, however.<sup>15</sup> Under SFAS 133, most hedging must be accomplished by a derivative, though nonderivatives may be used as hedging instruments in foreign currency fair value hedges and for hedges of the foreign currency exposure of a net investment in a foreign operation.<sup>16</sup>

---

<sup>12</sup> T.D. 8555, 1994-2 C.B. 180. Hedging of such transactions, at least where objective data beyond the control of the issuer is available, may produce integrated treatment under Treasury Regulation § 1.1275-6 (2000).

<sup>13</sup> This example is based on Example 4 FAIR VALUE HEDGE OF EQUITY SECURITIES WITH OPTION CONTRACTS, SFAS 133, § 85 (Financial Accounting Standards Bd. 1998).

<sup>14</sup> As discussed *infra*, a straddle is something of a lopsided hedge, requiring deferral of recognition of losses on loss positions until gain positions have also been recognized.

<sup>15</sup> Debt instruments may sometimes qualify as hedges under the tax law. Treasury Regulation § 1.1221-2(c)(3) notes that "a taxpayer's interest rate risk from a floating rate borrowing may be reduced by the purchase of debt instruments that bear a comparable floating rate." Treas. Reg. § 1.221-2(c)(3) (2000). This investment in the floating rate debt instruments will not be a hedging transaction unless the taxpayer can demonstrate that it purchased the debt instruments primarily to reduce risk. The regulation presumes that "borrowings generally are not made primarily to reduce risk." *Id.* Nevertheless, under Treasury Regulation § 1.1221-2(c)(6), "[w]hether hedges of a taxpayer's debt issuances (borrowings) are hedging transactions is determined without regard to the use of the proceeds from the borrowing." Treas. Reg. § 1.221-2(c)(6) (2000). Treasury Decision 8555, states that "IRS and Treasury believe that a liability hedge should not fail to qualify as a hedging transaction because the proceeds of the borrowing being hedged are used to purchase a capital asset." T.D. 8555, 1994-2 C.B. 180. Debt instruments may be integrated with other transactions under an accrual system if a yield to maturity can be established and certain other requirements are met. See discussion of Section 1.1275-6 hedges, *infra*.

<sup>16</sup> *Preliminary Views*, § 93 observes that if fair value accounting were required for all financial instruments, it would no longer be necessary to allow nonderivatives

A derivative is defined in SFAS 133 ¶ 6 as a financial instrument “or other contract” having three characteristics:

1. One or more underlyings and one or more notional amounts or payment provisions or both. A referenced asset or liability is not the underlying of a derivative contract, but the price or rate of the associated asset or liability that is used to determine the settlement amount of the derivative instrument is an underlying.<sup>17</sup> Multiplication, or other arithmetical interaction, of the notional amount and the underlying determines the settlement of the derivative.<sup>18</sup>
2. No requirement of an initial net investment, or requiring an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. Entering into a commodity futures contract generally requires no net investment, for instance, while purchasing the same commodity requires an initial net investment equal to its market price.<sup>19</sup>
3. Terms that require or permit net settlement, or allowing ready net settlement by a means outside the contract. The instrument may provide for delivery of an asset that puts the recipient in a position not substantially different from net settlement.<sup>20</sup>

A transaction that satisfies these requirements is a derivative, whether or not it is called one, or denominated one of the standard derivative categories—futures, forwards, options and swaps. The tax law, on the other hand, is not based on any broad concept of what a derivative is, but rather on the tax treatment of the specific kinds of derivative instruments.<sup>21</sup>

Under SFAS 133 ¶ 4, a derivative may, under appropriate circumstances, be designated as hedging:

---

to qualify as hedging instruments.

<sup>17</sup> SFAS 133 § 250.

<sup>18</sup> SFAS 133 § 251.

<sup>19</sup> SFAS 133 § 57(b).

<sup>20</sup> For a detailed discussion of net settlement see SFAS 133 § 259.

<sup>21</sup> Consequently, there is no particular need to define “derivative” in the tax law. Several regulations contain lists of derivative instruments (*e.g.*, Treas. Reg. § 1.861-9T(b)(6) (2000): “interest rate swaps, options, forwards, caps, and collars”), but the Code and regulatory writers always assume that they are addressing applications to specific financial instruments (even if the instrument must be integrated or bifurcated to be accounted for properly in the tax system).

1. Exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk (a fair value hedge).<sup>22</sup>
2. Exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction,<sup>23</sup> that is attributable to a particular risk (a cash flow hedge).
3. Foreign currency exposure of (1) an unrecognized firm commitment (a foreign currency fair value hedge), (2) an available-for-sale security (a foreign currency fair value hedge), (3) a forecasted transaction (a foreign currency cash flow hedge), or (4) a net investment in a foreign operation.

SFAS 133 generally provides for matching the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk, or the earnings effect of the hedged forecasted transaction.

Hedge accounting under SFAS 133 is divided into three general categories—fair value hedges, cash flow hedges and foreign currency hedges. SFAS 133 would generally cover the hedging concept envisioned in Treasury Regulation 1.1221-2 (b). There is, of course, no ordinary income requirement for financial accounting. Price changes are hedgeable under SFAS 133, which specifically says, regarding fair value hedges:

An entity may designate a derivative instrument as hedging the exposure to changes in the fair value of an asset or liability or an identified portion thereof (“hedged item”) that is attributable to a particular risk.<sup>24</sup>

An asset or liability, or an unrecognized firm commitment, can be designated as the hedged item in a fair value hedge if properly identified.<sup>25</sup>

---

<sup>22</sup> If fair value accounting were introduced for all financial instruments, as currently proposed in *Preliminary Views*, fair value hedging not involving foreign currency risk would only apply to nonfinancial items, such as inventory. *Preliminary Views*, § 92.

<sup>23</sup> If, as per note 22, *supra*, fair value accounting of financial instruments were introduced, cash flow hedges of forecasted transactions not involving foreign currency risk would be limited to those involving nonfinancial items. *Preliminary Views*, §§ 92-94.

<sup>24</sup> SFAS 133 § 20.

<sup>25</sup> SFAS 133 § 21(a). A firm commitment represents an asset or liability that a specific accounting standard prohibits recognizing, such as a noncancelable operating lease or an unrecognized mortgage servicing right.

The hedged item can also be a portfolio of similar assets or liabilities, or a specific portion of such assets or liabilities.

A cash flow hedge involves hedging the exposure of an asset or liability, or a forecasted transaction, to variability in expected future cash flows attributable to a particular risk. Foreign currency hedges can, in turn, be hedges of the fair value of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security), a cash flow hedge of a forecasted transaction, an unrecognized firm commitment, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany transaction, or a hedge of a net investment in a foreign operation.<sup>26</sup>

### III. BASIC METHODS OF ACCOUNTING FOR HEDGES

Section 446(b) indicates a general principle that a taxpayer's method of accounting should clearly reflect income. Treasury Regulation 1.446-4 provides general rules for the accounting of hedges, though this regulation excepts the following four categories of transactions:

1. Any position to which Section 475 applies—i.e., any position marked to market by a dealer in securities, or as to which a dealer in commodities, or a trader in commodities or securities, has elected Section 475 treatment. Thus, inventory securities, including most derivatives, will be marked to market by dealers.
2. A debt and a hedge integrated under Treasury Regulation 1.1275-6—with the resulting synthetic debt instrument accounted for generally under the original issue discount (OID) rules.
3. Any Section 988 hedging transaction that is integrated under Treasury Regulation 1.988-5—also resulting in integrated treatment of two or more transactions.
4. The determination of the issuer's yield on an issue of tax-exempt bonds for purposes of the arbitrage restrictions to which Treasury Regulation 1.148-4(h) applies.<sup>27</sup>

Treasury Regulation 1.446-4(b) sets out the "clear reflection of income" standard insofar as it can be broadly adapted to hedging:

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

<sup>26</sup> SFAS 133 § 36, as amended by SFAS 138 § 4(j).

<sup>27</sup> Treas. Reg. § 1.446-4(a)(2) (2000). For a discussion of Treasury Regulation § 1.148-4(h) see STEVEN D. CONLON & VINCENT M. AQUILINO, *PRINCIPLES OF FINANCIAL DERIVATIVES: U.S. AND INTERNATIONAL TAXATION* § B.3.06[a] (1999).

timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged.<sup>28</sup> Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions . . . . In the case of many hedging transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.

Thus, realization events of hedged items may appropriately be recognition events, but may not. Where the hedged item's realization controls, as is the general rule, the tax system allows for significant deferral. Matching becomes critical. The next provision in the regulation accepts that "there may be more than one method of accounting that satisfies the clear reflection of income requirement . . . ." <sup>29</sup> Indeed, "[d]ifferent methods of accounting may be used for different types of hedging transactions and for transactions that hedge different types of items."<sup>30</sup> Once a taxpayer adopts a method of accounting for a specific type of hedging transaction, it must be used consistently and can only be changed with the consent of the IRS.

In a transaction hedging purchases of inventory, for instance, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were an element in the cost of inventory. The same approach works with sales of inventory.<sup>31</sup>

*Example Two.* GoodBean Co., which uses the calendar year for financial and tax accounting purposes, forecasts the purchase of 500,000 pounds of Brazilian coffee for U.S. dollars six months from October 2000 and wants to hedge the cash flow exposure to changes in the U.S. dollar price of Brazilian coffee.<sup>32</sup> GoodBean enters into a six-month forward to purchase 500,000 pounds of Colombian coffee on March 15.

---

<sup>28</sup> Thus, under Treasury Regulation § 1.446-4(e)(1)(ii)(B) (2000), when a hedged transaction is marked to market, marking the hedge of that transaction will clearly reflect income. Treas. Reg. § 1.446-4(e)(1)(ii)(B) (2000).

<sup>29</sup> Treas. Reg. § 1.446-4(c) (2000).

<sup>30</sup> *Id.* If different methods are used for different types of hedging transactions, the specificity required in identification will be a greater burden. *See* Treas. Reg. § 1.446-4(d)(2) (2000).

<sup>31</sup> Treas. Reg. § 1.446-4(e)(3) (2000).

<sup>32</sup> Example 7: CASH FLOW HEDGE OF A FORECASTED PURCHASE OF INVENTORY WITH A FORWARD CONTRACT, SFAS 133 § 93.

GoodBean designates the forward as a cash flow hedge of its forecasted purchase of Brazilian coffee.

For financial accounting purposes under SFAS 133, GoodBean must, both at inception and on an ongoing basis, assess the effectiveness of the hedge by comparing changes in the expected cash flows from the Colombian coffee forward contract with the expected net change in cash outflows for purchasing the Brazilian coffee. Any ineffectiveness is reported currently in earnings. The effective portion of the forward would be deferred in other comprehensive income until the purchased coffee is sold.

From a tax perspective, the transaction hedges purchase of inventory, so gain or loss on the hedging transaction generally will be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory. Even if GoodBean used futures contracts that were covered by Section 1256, the hedge of inventory would qualify for an exception to mark-to-market treatment.

A taxpayer's inventory purchases and sales may be so complex, however, that "other simpler, less precise methods may be used in appropriate cases" and still satisfy the clear reflection of income requirement. Thus, marking a hedge to market may be an appropriate method of accounting, even though the inventory being hedged is not marked to market, but this will not be the case if the taxpayer uses the last-in, first-out method or the lower-of-cost-or-market method. To mark the hedge but not the inventory to market, items may only be held in inventory for a short period.<sup>33</sup>

*Example Three.*<sup>34</sup> Alko Co. has 20,000 MMBTUs of natural gas stored in West Texas. To hedge its exposure of the natural gas, the company sells the equivalent of 20,000 MMBTUs of natural gas futures contracts on a futures exchange. The futures prices are based on delivery of natural gas at the Henry Hub gas collection point in Louisiana.

The Standard's analysis of this fact pattern assumes that the hedge is as to the fair value exposure of the natural gas. Under SFAS 133, gain or loss on the hedging instrument is recognized currently in earnings. Similarly, gain or loss (change in fair value) of the hedged item attributable to the hedged risk adjusts the carrying amount of that item, and this is also recognized currently in earnings. If, for tax purposes, the hedging transaction hedges a sale of inventory, gain or loss on the hedging transaction may be taken into account when the sales pro-

---

<sup>33</sup> Treas. Reg. § 1.446-4(e)(3)(ii)(B) (2000).

<sup>34</sup> The facts are taken from Example 1: FAIR VALUE HEDGE OF NATURAL GAS INVENTORY WITH FUTURES CONTRACTS, beginning at SFAS § 73.

ceeds are taken into account.<sup>35</sup>

Because of the different locations of Alko's inventory and the delivery point on its future contracts, SFAS 133 ¶ 74 cautions that Alko will not be able to assume that the hedge will be highly effective. Some ineffectiveness still allows for hedge accounting. In such an instance, the ineffectiveness is recognized currently in earnings, with no offsetting adjustment of a hedged item's carrying amount. There is a limit to the amount of ineffectiveness that permits a hedging relationship, however, and an assessment must be made on an ongoing basis as to whether the degree of effectiveness is sufficient to allow for a hedging relationship. If the hedging relationship is not, or ceases to be, highly effective, the inventory and the futures contracts are accounted for separately under the appropriate accounting rules for each type of asset. This dismantling of a hedging relationship would only be permitted for tax purposes if the Service permitted a change in method of accounting.

Treasury Regulation 1.446-4(e)(3) indicates that the basic treatment of an inventory hedge depends on whether purchases or sales of inventory are being hedged. To qualify for hedging treatment, the futures transaction in this example must manage risk of price changes (or currency fluctuations) on the inventory.<sup>36</sup>

*Example Four.* Bedner Corp. manufactures tires, which involves maintaining supplies of rubber, steel, paints, and other components.<sup>37</sup> Bedner hedges its tire inventory by entering into forward contracts to sell rubber at fixed prices. Though the Standard's analysis indicates that "[i]t is unlikely that this transaction would be highly effective in achieving offsetting changes in fair value," nevertheless the Statement's analysis concedes that Bedner may be able to establish that the forward contracts are highly effective in this regard. Under SFAS 133 ¶ 21(e), if a hedged item is a nonfinancial asset or liability, the risk hedged must be the risk of changes in the fair value of the entire hedged asset. Thus, hedging the exposure to changes in the fair value of gasoline may not be accomplished by designating the risk being hedged as the price of crude oil. Nevertheless, an instrument based on the price of crude oil may, on occasion, hedge the value of gasoline.

From a tax perspective there is no "highly effective" requirement for hedging, and the transaction qualifies for tax hedge accounting as

---

<sup>35</sup> If a hedge cannot be associated with a particular purchase or sales transaction, the mark-and-spread method of Treasury Regulation § 1.446-4(e)(1)(ii) may be used, with adjustment as indicated in the last sentence of Treasury Regulation § 1.446-4(e)(3).

<sup>36</sup> Treas. Reg. § 1.1221-2(c)(1) (2000). See discussion of risk reduction, *infra*.

<sup>37</sup> This example is adapted from Example 2: FAIR VALUE HEDGE OF TIRE INVENTORY WITH A FORWARD CONTRACT, beginning at SFAS 133 § 78.

long as the rubber forward manages the taxpayer's risk on sales of tires, and was purchased with this intent. The fact that the taxpayer's policy is to reduce risk on its inventory of tires by selling rubber forwards should help establish the fact that there is risk reduction because, under Treasury Regulation 1.1221-2(c)(1), "a taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions reduce the taxpayer's risk."

If the hedge continues after an item being hedged is disposed of, "the taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item."<sup>38</sup> This can be done by marking the hedge to market on the date of disposition of the hedged item. This marking to market can be avoided if the hedge is disposed of within "a reasonable period," which, under Treasury Regulation 1.446-4(e)(6), is generally within seven days.

#### IV. EMBEDDED DERIVATIVES

It is a cornerstone of the system developed in SFAS 133 that a derivative embedded in another financial instrument will generally be separated from its host contract and accounted for separately. The following criteria must be met for this treatment:

1. The economic characteristics and risks of the embedded derivative instrument must *not* be clearly and closely related to the economic characteristics and risks of the host.
2. The hybrid instrument that embodies both the embedded derivative and the host cannot be remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.<sup>39</sup>

---

<sup>38</sup> Treas. Reg. § 1.446-4(e)(6) (2000).

<sup>39</sup> Financial Accounting Standards Board, *Derivatives Implementation Group Implementation Issue No. B 24* (Aug. 2000) concludes that a structured note with a contingent payment feature correlated with an index may contain an embedded derivative that must be separated from the host. The Issue posits that the entity issuing the structured note applied the consensus in Emerging Issues Task Force Issue No. 86-28 *Accounting Implications of Indexed Debt Instruments*, under which the issuer did not allocate proceeds to the contingent payment feature, and any change in the liability resulting from a change in the relevant index value has been recorded as an adjustment of the carrying amount of the debt obligation. The entire instrument would not have to be remeasured at fair value, but if the contingent feature were not clearly and closely related to the structured note, and if it would be a derivative if free-standing, it must be accounted for under SFAS 133.

3. A separate instrument with the same terms as the embedded derivative instrument would be a derivative instrument subject to the requirements of SFAS 133.<sup>40</sup>

The most complex question from this list will usually be the determination of whether the embedded derivative is so clearly and closely related to the host as to be inseparable from it. An embedded derivative for which the underlying is an interest rate or interest rate index (an interest rate cap or collar) that alters net interest payments that would otherwise be paid or received on an interest-bearing host contract is clearly and closely related to the host contract unless leverage is involved.<sup>41</sup> Where the host contract is a debt instrument but an embedded derivative creates a possibility of a return based on the value of a particular stock, or stock index, the embedded derivative incorporating the equity-based return is not clearly and closely related to the host contract and must be separate from it and accounted for as a freestanding derivative.

*Example Five.* FidoCo issues five-year, fixed-rate debt with an embedded call option based on a stock index. With a different counterparty, FidoCo writes a call option to neutralize the call feature in the debt.<sup>42</sup> If the embedded call and the written call have the same notional amounts, underlying fixed interest rates, and strike prices, and if they can be exercised at the same times, the written call may be highly effective in offsetting changes in fair value of the embedded derivative.<sup>43</sup>

From a tax perspective, the debt with the embedded call may be treated as a contingent payment debt instrument and generally accounted for under the noncontingent bond method of Treasury Regulation 1.1275-4. If so, the next issue is whether the written call can be considered a hedge as to the debt instrument (including its embedded option). The two instruments may be integrated by the taxpayer under Treasury Regulation 1.1275-6 if the requirements for integration are met.<sup>44</sup> Under the gen-

---

<sup>40</sup> SFAS 133 § 12.

<sup>41</sup> SFAS 133 § 13.

<sup>42</sup> Facts adapted from Example 6: FAIR VALUE HEDGE OF AN EMBEDDED PURCHASED OPTION WITH A WRITTEN OPTION, beginning at SFAS 133 § 91.

<sup>43</sup> The Statement notes that the hedge is likely to have some ineffectiveness because the premium for the written call is unlikely to be the same as that of the embedded derivative. SFAS 133 § 92.

<sup>44</sup> The requirements include that the combined cash flows permit the calculation of a yield to maturity, such as is found under Treasury Regulation 1.1275-5 for a variable rate debt instrument. Treasury Regulation § 1.1275-6(b)(2)(i) (2000). If the taxpayer qualifies for such integrated treatment, but does not use the method, it is doubtful that the IRS would impose integration since the facts do not meet the types of circumstances that are listed as justifying the Service in

eral hedging rules, the written option is likely to manage risk as to interest rate or price changes on the debt,<sup>45</sup> so that gain or loss must be accounted for by reference to the terms of the debt instrument and the period to which the hedge relates.<sup>46</sup>

More than one derivative can hedge more than one risk. An embedded derivative might hedge one risk as to the host contract. As noted at SFAS 133 ¶ 414:

[A]n embedded derivative in a hedged item will modify the nature of the risk to which that item is exposed. Thus, all embedded derivatives relating to the same risk class (that is, market prices, market interest rates, foreign exchange rates, or credit) in a hedged item must be considered together in assessing the effectiveness of an additional (freestanding) derivative as the hedging instrument.

An embedded foreign currency derivative is not separated from a host contract if the host is not a financial instrument and it requires payments denominated in (1) the currency of the primary economic environment in which any substantial party to that contract operates (that is, its functional currency), or (2) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions).<sup>47</sup>

If an embedded derivative instrument is separated from its host, the host is accounted for under generally accepted accounting principles applicable to instruments of that type that do not contain embedded derivatives. The FASB “expects the clearly-and-closely-related approach to affect a significant number and wide variety of structured notes and other contracts that include embedded derivatives.”<sup>48</sup> The Board also notes that “[a]pplying the approach will require judgment, which may lead to different accounting for similar instruments.”<sup>49</sup>

A hybrid instrument might contain more than one embedded derivative, raising the question of whether each embedded instrument must be separated from the host and accounted for separately. Though not answered in the Statement itself, the Derivatives Implementation

---

imposing integration. Treas. Reg. § 1.1275-6(c)(2) (2000). Those circumstances are, however, not exclusive. In any case, if the general hedging rules are followed, there would seem to be no reason for the IRS to impose integration.

<sup>45</sup> Treas. Reg. § 1.1221-2(b)(2) (2000).

<sup>46</sup> Treas. Reg. § 1.446-4(e)(4) (2000).

<sup>47</sup> SFAS 133 § 15.

<sup>48</sup> SFAS 133 § 306.

<sup>49</sup> *Id.*

Group,<sup>50</sup> and the FASB staff, have considered the issue and promulgated guidance indicating:

If a hybrid instrument contains more than one embedded derivative feature that would individually warrant separate accounting as a derivative under [SFAS 133 ¶ 12], those embedded derivative features must be bundled together as a single, compound embedded derivative instrument that would then be bifurcated and accounted for separately from the host contract under Statement 133.<sup>51</sup>

Though SFAS 133 is, as has been noted, generally a bifurcation system, there may be occasions when integration will be necessary. Thus, two loans between entities for the same period on the same notional, one for a fixed rate and one for a floating rate, may appropriately be integrated to be treated for financial accounting as a swap.<sup>52</sup>

If an entity cannot reliably identify and measure an embedded derivative that SFAS 133 requires be separated from the host contract, the entire contract is measured at fair value with gain or loss recognized in earnings. If the latter treatment is imposed, the entire instrument cannot designated as a hedging instrument under SFAS 133.<sup>53</sup>

<sup>50</sup> The Derivatives Implementation Group is a task force of derivatives industry experts created to assist the FASB in answering questions that companies will face when they begin implementing SFAS 133. The model for the Group was the FASB's Emerging Issues Task Force with the key difference being that the Group does not formally vote on issues to reach a consensus. After each meeting of the Derivatives Implementation Group, the FASB staff has the responsibility of documenting tentative conclusions reached by the group. Those conclusions will remain tentative until they are formally cleared by the FASB and become part of a FASB staff implementation guide.

<sup>51</sup> Statement 133 Implementation Issue No. B 15, *Embedded Derivatives: Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument*, (visited Oct. 6, 2000) <<http://www.rutgers.edu/Accounting/raw/Fasb>>.

<sup>52</sup> See Statement 133 Implementation Issue No. K 1, *Determining Whether Separate Transactions Should be Viewed as a Unit*, (Feb. 17, 1999) *supra* note 6. See also Statement 133 Implementation Issue No. K 3, *Determination of Whether Combinations of Options With the Same Terms Must Be Viewed as Separate Option Contracts or as a Single Forward Contract*, (May 17, 2000). Most recently, see Financial Accounting Standards Board, *Derivatives Implementation Group Implementation Issue No. F 6*, (Aug. 2000) (discussing the possibility of integrating two mirror-image interest rate swaps entered into with the same counterparty).

<sup>53</sup> SFAS 133 §§ 178 — 200 contain twenty-two examples of different types of embedded derivatives, and whether they must be separated from their hosts. This has also been an active discussion area for the Derivatives Implementation

## V. RISK REDUCTION OR RISK MANAGEMENT?

The tax regulatory drafters struggled, as did the FASB and its staff, with the issue of whether a hedge should reduce the taxpayer's overall risk. In issuing the final regulations under Section 1221, the Treasury indicated that the issue had been debated:

A number of commentators suggested that the IRS abandon the rule [that a hedge be entered into primarily to *reduce* the risk of interest rate or price changes or currency fluctuations] of the proposed regulations and adopt a definition of hedging that looks to risk management rather than risk reduction. This comment was not adopted because the IRS and Treasury believe that the definition of section 1256 [Section 1256(e)(2), specifying that a hedging transaction must be entered into primarily "to reduce risk"] represents the best indication of congressional intent with respect to business hedges. Although the risk reduction standard has been retained, the final regulations provide rules of application designed to ensure that the definition of hedging transaction is applied reasonably to include most common types of hedging transactions.<sup>54</sup>

Congressional intent has now shifted towards requiring risk management instead of risk reduction. With the Tax Relief Extension Act of 1999, Congress recognized "that a 'risk management' standard better describes modern business hedging practices that should be accorded ordinary character treatment."<sup>55</sup> Presumably, Treasury Regulation 1.1221-2(c)(1)(vii), boldly stating that "a transaction that is not entered into to reduce a taxpayer's risk is not a hedging transaction" will be withdrawn.

Under SFAS 133, an entity is encouraged to state its hedging strategies and policies. Under ¶ 44:

Qualitative disclosures about an entity's objectives and strategies for using derivative instruments may be more meaningful if such objectives and strategies are described in the context of an entity's overall risk management profile. If appropriate, an entity is encouraged, but not required, to provide such additional qualitative disclosures.

The Standard, however, eliminates a previous requirement that an entity demonstrate risk reduction on an entity-wide basis to qualify for hedge

---

Group.

<sup>54</sup> T.D. 8555, 1994-2 C.B. 180.

<sup>55</sup> S. REP. No. 106-120, at 195 (1999).

accounting.<sup>56</sup> The provision was difficult, if not impossible, to comply with, and may have discouraged appropriate use of derivatives in hedging transactions.

Nevertheless, the issue may not be dead with the FASB. In ¶ 357 (part of the Background Information and Basis for Conclusions), the Statement indicates that “entity-wide risk reduction should be a criterion for hedge accounting.” The discussion indicates that this was not possible to keep as a requirement because:

[R]equiring that a derivative contribute to entity-wide risk reduction would necessitate a single, restrictive definition of risk, such as either fair value risk or cash flow risk. Actions to mitigate the risk of a change in fair value generally exacerbate the variability of cash flows. Likewise, actions to mitigate the variability of cash flows of existing assets and liabilities necessitate “fixing” cash flows, which in turn generally exacerbates an entity’s exposure to changes in fair value. Because this Statement provides hedge accounting for both fair value risk and cash flow risk, an objective assessment of entity-wide risk reduction would be mechanically impossible in most situations. Therefore, the Board did not continue the requirement in Statement 80 that a hedging transaction must contribute to reducing risk at the entity-wide level to qualify for hedge accounting.

This would seem to indicate that if cash-flow hedge accounting were eliminated, or if some financial engineer could prove that an entity-wide risk measurement system could handle all risks recognized under SFAS 133, the requirement for entity-wide risk reduction might be reintroduced.<sup>57</sup>

---

<sup>56</sup> SFAS 133 §§ 239, 242, 243. SFAS 80 had contained an entity-wide risk reduction requirement.

<sup>57</sup> In § 449, the Statement seems less optimistic in its discussion of macro hedging, noting that “[m]acro hedging seems to imply a notion of entity-wide risk reduction.” The absence of any practical means of establishing this is sufficient for dismissing the kind of portfolio hedging required under Treasury Regulation § 1.246-5 (2000). “The Board also believes that permitting hedge accounting for a portfolio of dissimilar items would be appropriate only if risk were required to be assessed on an entity-wide basis.” The difficulty of enforcing a portfolio hedging system is discussed at length in John J. Ensminger, *The Broad but Porous Net of the Straddle Rules: How Long Will the Fish Continue to Swim Through?* 18 VA. TAX REV., 709 (1999).

That overall risk reduction was not much more than wishful thinking on the part of the Treasury was probably acknowledged by Treasury Regulation 1.1221-2(c)(1)(v), which indicates that a transaction entered into primarily to counteract all or part of the risk reduction accomplished by another hedging transaction is itself a hedging transaction. Must a hedging transaction that removes the effect of another hedging transaction itself decrease the entity's overall risk? In issuing the regulations, the Treasury provided a comment that only added to the confusion:

This rule recognizes that some transactions are used to eliminate some or all of the risk reduction accomplished through a hedging transaction. Although the transactions are not risk reducing if viewed independently, they are considered to be part of the larger hedging transaction.<sup>58</sup>

Quite obviously, eliminating the effect of a hedging transaction may sometimes increase overall risk. In a sufficiently complex enterprise, determining the risk consequences of a transaction will often depend on whether there is an effective overall risk measurement as to the enterprise's activities. Different assumptions, and different programs, can produce conflicting conclusions.

Under Treasury Regulation 1.1221-2(c)(1)(iv), a taxpayer may hedge "all or any portion of its risk for all or any part of the period during which it is exposed to risk." Under SFAS 133 ¶ 21(a), a hedged item must be specifically identified as "either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment." Also under that paragraph, a hedged item can be a portfolio of similar assets or similar liabilities, or a specific portion thereof. Frequent entering into and termination of positions (even if done daily or more frequently) is not, according to Treasury Regulation 1.1221-2(c)(1)(vi), relevant to whether transactions are hedging transactions.<sup>59</sup> Under the general timing requirements of Treasury Regulation 1.446-4, a taxpayer hedging aggregate risk must comply with the matching requirements of Treasury Regulation 1.446-4(b).<sup>60</sup>

Treasury Regulation 1.446-4(b) indicates, as noted above, that "[t]o clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged." The regulation acknowledges that a taxpayer hedg-

---

<sup>58</sup> T.D. 8555, 1994-2 C.B. 180.

<sup>59</sup> Such frequency can limit the integration of debt instruments under Treasury Regulation § 1.1275-6. See Treas. Reg. § 1.1275-6(c)(1)(v) (2000).

<sup>60</sup> Treas. Reg. § 1.446-4(e)(1) (2000).

ing at such a macro level “may not be able to associate the hedging transaction with any particular item being hedged.” Even here, however, “the timing of income, deduction, gain, or loss from the hedging transaction must be matched with the timing of the aggregate income, deduction, gain, or loss from the items being hedged.” Under the mark-and-spread method, hedging transactions are marked to market at least quarterly.<sup>61</sup>

The replacement of a risk reduction requirement with a risk management requirement in the Code reflects a recognition of modern risk management practices, and whatever thoughts the FASB has had about abandoning such an approach should probably be dismissed.

#### VI. DESIGNATION

Both financial and tax accounting require that hedge relationships be designated by those entering into them, though the tax system grants the IRS authority to provide the designation in a number of circumstances.

For both fair value<sup>62</sup> and cash flow hedges<sup>63</sup> (and foreign currency fair value<sup>64</sup> and cash flow<sup>65</sup> hedges), financial accounting requires formal documentation of the hedging relationship and the entity’s risk management “objective and strategy for undertaking the hedge” at its inception. The identification must indicate what risk is being hedged, and how the hedging instrument’s effectiveness in offsetting the exposure to changes in the hedged item’s fair value, or cash flows, attributable to the hedged risk is to be assessed. There must be a “reasonable basis” for how the entity plans to assess the hedging instrument’s effectiveness. Under SFAS 133 ¶ 63, all or a part of a hedging instrument’s time value can be excluded from the assessment of hedge effectiveness.

The FASB’s approach to documentation is elucidated to a degree in SFAS 133 ¶ 385:

The Board decided that concurrent designation and documentation of a hedge is critical; without it, an entity could retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result. The Board also decided that identifying the nature of the risk being hedged and using a

---

<sup>61</sup> Treas. Reg. § 1.446-4(e)(1)(ii) (2000).

<sup>62</sup> SFAS 133 § 20(a).

<sup>63</sup> SFAS 133 § 28(a).

<sup>64</sup> SFAS 133 § 37, cross-referencing § 20.

<sup>65</sup> SFAS 133 § 40(c), cross-referencing § 28.

hedging derivative consistent with an entity's established policy for risk management are essential components of risk management and are necessary to add verifiability to the hedge accounting model.<sup>66</sup>

There is some hint that the FASB might not be through in this area. In SFAS 133 ¶ 390, the commentary notes that the Board may need to revisit the idea of more specific effectiveness tests "if an evaluation of the application of this Statement indicates either too great a disparity in the techniques used for assessing effectiveness or widespread abuse of the flexibility provided."

For tax purposes, Treasury Regulation 1.1221-2(e)(1) specifies that a taxpayer entering into a hedging transaction—including recycling an existing hedge—must identify the hedging transaction before the close of the day on which the taxpayer enters into the transaction.<sup>67</sup> The identification of a hedging transaction under Section 1256(e)(2) must also satisfy this same day requirement (except as to the ordinary treatment specified in Section 1256(f)(1)).<sup>68</sup> Under Treasury Regulation 1.446-4(e)(7), built-in gain or loss on the original hedge must be matched at the time of the recycling to gain or loss on the original hedged "item, items, or aggregate risk."<sup>69</sup>

Under Treasury Regulation 1.1221-2(e)(2), a substantially contemporaneous identification must be made of the item being hedged. The regulation specifies that an identification made more than 35 days after entering into the hedging transaction is not substantially contemporaneous. If the hedging is of an anticipated acquisition of assets, the identification must state the expected date or dates of acquisitions and the amounts expected to be acquired.<sup>70</sup> If the hedging is of the purchase or sale of inventory, the identification must specify the type or class of inventory, and the expected dates and amounts of any purchases or sales

---

<sup>66</sup> See also SFAS 133 § 458.

<sup>67</sup> See also § 1.988-5(b)(3) with respect to hedged executory contracts. This section also applies, under proposed regulations, to hedges of certain nonfunctional currency payments. Prop. Treas. Reg. § 1.988-5(d)(2)(A).

<sup>68</sup> 26 U.S.C. § 1256(f)(1) can characterize *gain* as ordinary if the taxpayer has identified property as part of a hedge, even if it could not qualify as a hedge because loss (and gain) would be capital. 26 U.S.C. § 1256(f)(1) (2000). See Field Service Advice 19991101 (advice from 1993).

<sup>69</sup> Afterwards, of course, the hedge must be accounted for in relation to the new hedged item.

<sup>70</sup> Treas. Reg. § 1.1221-2(e)(3)(i) (2000). See Treasury Regulation § 1.446-4(e)(8) (2000) regarding unfulfilled anticipatory transactions.

involved.<sup>71</sup> If the hedging is of debt issued by the taxpayer, the identification must specify the issue and, if the hedge is of less than the full adjusted issue price or the full term of the debt, the amount and term covered by the hedge.<sup>72</sup> If the hedging is of an *aggregate risk*, the identification must specify the risk being hedged and the hedging program. This would suggest that the taxpayer must demonstrate how the “tail”—the risks remaining after the transactions offsetting to each from the taxpayer’s operations have been eliminated—is calculated. The final sentence of Treasury Regulation 1.1221-2(e)(3)(iv) would, however, seem to excuse such sophistication:

This requirement [of identifying the risk being hedged and the hedging program] may be met by placing in the taxpayer’s records a description of the hedging program and by establishing a system under which individual transactions are identified as being entered into pursuant to the program.<sup>73</sup>

The tax timing regulations cross-reference the requirements of Treasury Regulation 1.1221-2(e), but add that, in addition to the requirements of that section, the books and records maintained by the taxpayer must contain “whatever more specific identification with respect to a transaction is necessary to verify the application of the method of accounting used by the taxpayer for the transaction.”<sup>74</sup> The description of the method must be sufficient to show that the clear reflection of income requirement of Treasury Regulation 1.446-4(b) is being satisfied.<sup>75</sup>

---

<sup>71</sup> Treas. Reg. § 1.1221-2(e)(3)(ii) (2000).

<sup>72</sup> Treas. Reg. § 1.1221-2(e)(3)(iii)(A) (2000). If the hedge relates to an expected issuance of debt, Treasury Regulation § 1.1221-2(e)(iii)(B) provides some specificity as to the identification estimates.

<sup>73</sup> In Private Letter Ruling 98-32-020, a corporation held physical inventory, entered into forward contracts to buy and sell commodities, and hedged its net exposure between its physical inventory and its contracts with third parties. Priv. Ltr. Rul. 98-32-020 (May 17, 1998). Under an “aggregate hedging program,” the corporation attempted to balance long positions (physical inventory and contracts to buy commodities) and short positions (contracts to sell commodities), and entered into hedging contracts in an effort to maintain a balanced position. *Id.* This approach met the clear reflection of income requirement of Treasury Regulation § 1.446-4(b), despite the fact that the corporation “is generally unable to determine if any specific hedging contract is a hedge of future purchases, future sales, or physical inventory, or a partial or total offset of a pre-existing hedge.”

<sup>74</sup> Treas. Reg. § 1.446-4(d)(2) (2000).

<sup>75</sup> Treas. Reg. § 1.446-4(d)(1) (2000).

Where the hedge is of aggregate risk, the taxpayer must identify the aggregate risk and provide "sufficient additional information to demonstrate that the program is *designed* to reduce the aggregate risk of the type identified."<sup>76</sup> If the program contains controls on speculation—one wonders if a derivatives disaster was in some regulation writer's mind—"the description of the hedging program must also explain how the controls are established, communicated and implemented."

The identification must be made in the tax records. Identification for financial accounting or regulatory purposes does not satisfy this requirement "unless the taxpayer's books and records indicate that the identification is also being made for tax purposes."<sup>77</sup> The regulatory examples indicate that identification is acceptable by placing a hedging transaction in an account identified as containing only hedges of a specified item, items, or aggregate risk.<sup>78</sup> It would apparently be enough to place a specific mark on a trading ticket, purchase order, or trade conformation.<sup>79</sup>

The tax regulations acknowledge that identification might be inadvertent, and allow the taxpayer to avoid the mistaken choice provided the transaction is, in fact, not a hedging transaction. Similarly, a taxpayer may fail to identify a transaction as a hedging transaction even though it is one. Again, it is possible for the taxpayer to correct this mistake.<sup>80</sup>

An anti-abuse rule is provided the IRS for enforcement. Under Treasury Regulation 1.1221-2(f)(2)(iii), if the taxpayer "has no reasonable grounds for treating the transaction as other than a hedging transaction, then gain from the transaction is ordinary." Whether the failure to treat a hedging transaction other than as one is reasonable depends on how similar transactions have been treated by the taxpayer, and on *how the transaction is treated for financial accounting* and other purposes. So, even though financial accounting treatment is not sufficient to satisfy tax identification requirements, the IRS can use financial accounting as evidence of how the transaction should be treated for tax purposes.

As previously mentioned, the Service has the authority to integrate a qualifying debt transaction and a Treasury Regulation 1.1275-6 hedge.<sup>81</sup> Under Treasury Regulation 1.1275-6(f)(11), if the IRS requires integration, it "may treat a financial instrument that is not a § 1.1275-6

<sup>76</sup> Treas. Reg. § 1.1221-2(e)(3)(iv)(B) (2000) (emphasis added).

<sup>77</sup> Treas. Reg. § 1.1221-2(e)(4)(ii) (2000).

<sup>78</sup> Treas. Reg. § 1.1221-2(e)(4)(iv), Example (A) (2000).

<sup>79</sup> Treas. Reg. § 1.1221-2(e)(4)(iv), Example (C) (2000).

<sup>80</sup> As was done in Private Letter Ruling 97-06-002, allowing a taxpayer to rectify its failure to identify forward rate agreements and swaps as hedging transactions. Priv. Ltr. Rul. 97-06-002 (Feb. 7, 1997).

<sup>81</sup> Treas. Reg. § 1.1275-6(c)(2) (2000).

hedge as a § 1.1275-6 hedge” since it is empowered to make appropriate adjustments. Since a Treasury Regulation 1.1275-6 hedge can be any financial instrument that when combined with another produces allows for a calculation of a yield to maturity or for the creation of variable rate debt instrument, this allows the IRS to create a hedge even if the two transactions do not have the same term.<sup>82</sup> In any case, the “issue date of the synthetic debt instrument is the date determined appropriate by the Commissioner to require integration.”<sup>83</sup>

For currency hedging transactions, Treasury Regulation 1.988-5(a)(8) requires that before the close of the date a hedge is entered into, the taxpayer must record the date the debt and its hedge were entered into, and the date they constitute a “qualified hedging transaction.” The taxpayer must also provide in the record a summary of the cash flow resulting from treating the debt and the hedge as an integrated transaction (which should include a calculation of the yield to maturity of the synthetic instrument). The IRS can impose hedging treatment on two or more transactions if “[o]n the basis of all the facts and circumstances, the Commissioner concludes that the qualifying debt instrument and the hedge are, in substance, a qualifying hedging transaction . . . .” The Service has the same authority as to hedged executory contracts and bona fide hedging transactions under the foreign personal holding company provisions.<sup>84</sup>

## VII. ISSUES ON SPECIFIC FINANCIAL TRANSACTIONS

### A. Options

Under SFAS 133 ¶ 20(b), for fair value hedges:

If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, the increases (or decreases) in the fair value of the hedging instrument must be expected to be highly

---

<sup>82</sup> Rev. Rul. 2000-12, 2000-11 I.R.B. 1 allowed the Commissioner to integrate two transactions with different terms, but relied principally on the anti-abuse rule in Treasury Regulation § 1.1275-2(g)(2) (see discussion in text *infra*). Treasury Regulation § 1.1275-6(b)(2)(ii)(B) provides that if the hedge is itself a debt instrument, the hedge and the hedged item must have the same maturity. The same requirement does not apply to other hedges.

<sup>83</sup> Treas. Reg. § 1.1275-6(f)(11) (2000).

<sup>84</sup> Treas. Reg. § 1.988-5(b)(3)(ii) (2000); Treas. Reg. § 1.954-2(a)(4)(ii)(C)(5) (2000).

effective in offsetting the decreases (or increases) in the fair value of the hedged item.<sup>85</sup>

More specifically in SFAS 133 ¶ 398:

The requirements in this Statement for hedge accounting for strategies that use written options are based on symmetry of the gain and loss potential of the combined hedged position. To qualify for hedge accounting, either the upside and downside potential of the net position must be symmetrical or the upside potential must be greater than the downside potential. That is, the combination of the hedged item and the written option must result in a position that provides at least as much potential for gains (or favorable cash flows) as exposure to losses (or unfavorable cash flows). Evaluation of the combined position's relative potential for gains and losses is based on the effect of a favorable or unfavorable change in price of a given percentage.

Under the general rule of Treasury Regulation 1.1221-2(c)(1), an option can satisfy the requirement of reducing risk, even if it is not as effective as the FASB requires. If there is any doubt, however, Treasury Regulation 1.1221-2(c)(1)(iii) states that a "written option may reduce risk." The regulation specifies that this can be the case with a written call option for assets held by a taxpayer, or a written put option for assets to be acquired by the taxpayer.

For an at-the-money put option on a Treasury security, an example in the Standard indicates that the owner could "assess whether it expects the hedge to be highly effective at achieving offsetting changes in fair value by calculating and comparing the changes in the intrinsic value of the option and changes in the price (fair value of the Treasury bond for different possible market prices."<sup>86</sup>

### *B. Notional Principal Contracts*

A notional principal contract is generally a swap, cap, or floor or similar instrument. The term is more specifically defined for the tax law in Treasury Regulation 1.446-3(c) as follows:

---

<sup>85</sup> Virtually the same language is found in SFAS 133 § 28(b) for cash flow hedges.

<sup>86</sup> SFAS 133 § 89. An option embedded in an existing asset or liability (unless that asset or liability is itself an embedded derivative) is accounted for separately.

A notional principal contract is a financial instrument that 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 specified consideration or a promise to pay similar amounts.<sup>87</sup>

The regulation indicates that a contract between business units of the same corporation cannot be a notional principal contract because a taxpayer does not have contracts with itself. A collar—a combination of call and put options—is not itself a notional principal contract, but a call and a put together may sometimes be a single notional principal contract. A notional principal contract is not a future, forward, or option, nor does the term include an option or forward that entitles or obligates a person to enter into a notional principal contract.

The basic method of accounting for notional principal contracts requires that “[f]or all purposes of the Code, the net income or net deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year.”<sup>88</sup> Net income or deductions are determined for periodic and nonperiodic payments received under the contract. As to periodic payments, payable at intervals of one year or less during the entire term of the contract, “[a]ll taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of the periodic payment for the taxable year to which that portion relates.”<sup>89</sup>

*Example Six.* On April 1, 2000, Arkcan Corp. enters into a contract with Barkdale Corp. under which, for five years, Arkcan is obligated to make a payment to Barkdale each April 1, beginning April 1, 2001, in an amount equal to LIBOR as determined on the immediately preceding April 1 on a notional amount of \$100 million.<sup>90</sup> Barkdale, on the other hand, makes a fixed payment every April 1 of 8 times the same amount.

On April 1, 2000, LIBOR is 7.8 percent. On April 1, 2001, Barkdale pays \$8 million ( $8\% \times \$100,000,000$ ) to Arkcan, while Arkcan pays Barkdale \$7.8 million ( $7.8\% \times \$100,000,000$ ). The ratable daily portions for 2000 are the amounts of the payments attributable to the two taxpayers' taxable years ending December 31, 2000. The ratable daily portion of the fixed leg is \$6,010,929 ( $275 \text{ days}/366 \text{ days} \times \$8 \text{ million}$ ) and the ratable daily portion of the floating leg is \$5,860,656 ( $275/366 \times$

---

<sup>87</sup> For explanations of terms used in this definition, see Treasury Regulation § 1.446-3(c)(2), (3), and (4) (2000).

<sup>88</sup> Treas. Reg. § 1.446-3(d) (2000).

<sup>89</sup> Treas. Reg. § 1.446-3(3)(2) (2000).

<sup>90</sup> Treas. Reg. § 1.446-3(e)(3), Example (1) (2000).

\$7.8 million). The net amount for 2000 is the difference between these amounts (which are generally, under modern swap mechanics, going to be netted), \$150,273 (\$6,010,929 - \$5,860,656). Thus, Arkcan has net income of \$150,273 for 2000, while Barkdale has a net deduction of the same amount.

For financial accounting purposes, the swap is a derivative accounted for under the general fair valuation requirement of SFAS 133 ¶ 17 that all derivatives are to be measured at fair value. If the swap operates as a hedge for either party, the hedge accounting rules of the Standard will apply, depending on what the instrument is hedging.

A swap, cap or floor may involve nonperiodic payments—defined in Treasury Regulation 1.446-3(f)(1) as a payment that is not periodic and that is not a termination payment. The general method of tax accounting for such payments is that “[a]ll taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates.” Generally, recognition will be spread over the entire term of the notional principal contract.<sup>91</sup> Specifically as to a swap, a nonperiodic payment on a swap is allocated “in accordance with the forward rates (or, in the case of a commodity, the forward prices) of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount.” The IRS indicates that it will respect the forward rates or prices “if reasonable.”<sup>92</sup>

*Example Seven.* On January 1, 2001, LIBOR is eight percent and FinArk pays EdCar \$600,000 for a contract obligating EdCar to make a payment to FinArk each quarter equal to one-fourth of the excess, if any, of three-month LIBOR over nine percent on a notional amount of \$25 million. Both EdCar and FinArk are calendar year taxpayers.<sup>93</sup> EdCar provides FinArk with a schedule of allocable premium amounts indicating that the cap was priced according using the Black-Scholes option pricing formula, and price is allocated to the following periods using a variation of that model:

2001	\$ 55,000
2001	225,000
2003	<u>320,000</u>
	600,000

The payments made by EdCar are periodic payments, but the premium paid by FinArk works as a cap and is a nonperiodic payment.

---

<sup>91</sup> “[I]n a manner that reflects the economic substance of the contract.” Treas. Reg. § 1.446-3(f)(2)(ii) (2000).

<sup>92</sup> *Id.*

<sup>93</sup> Treas. Reg. § 1.446-3(f)(4), Example (1) (2000).

Since the Black-Scholes model is recognized as a standard in the financial industry, the above schedule can be used by both parties in calculating ratable daily portions of the premium. EdCar recognizes the ratable daily portion of the premium as income, and FinArk takes those portions as a deduction. Net income or net deduction for each will be determined by combining these allocations with the LIBOR-based payments from EdCar.<sup>94</sup> Thus, if three-month LIBOR, is ten percent throughout 2001, 9.5 percent throughout 2002, and nine percent throughout 2003, the net income and deductions for each year is as follows:

	Cap Allocation	E to F	Net
2001	\$ 55,000	\$62,500	(7,500)
2002	225,000	31,250	193,750
2003	320,000	0	320,000

This is one instance where the regulatory drafters opted for a kind of segregation approach to a derivative embedded in another derivative.

The Derivatives Implementation Group has considered two similar structures in Implementation Issue No. A 9, regarding prepaid interest rate swaps. There, where the fixed leg of a fixed-for-floating swap was prepaid, the first question was whether the transaction is a derivative at all because one of three factors in the definition of a derivative in ¶ 6 is that the instrument must require “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.” In elaborating on the meaning of “no initial net investment,” SFAS ¶ 8 specifies that a “derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying.” This would seem to indicate that the swap would not be a derivative.<sup>95</sup> In Implementation Issue No. A 9,<sup>96</sup> however, where the fixed leg of a fixed-to-floating swap was prepaid, the Derivatives Implementa-

<sup>94</sup> *Id.* See Example (7) for a calculation using commodity prices.

<sup>95</sup> If the swap were not a derivative (an odd result), the next question would be whether it contains a derivative. The Derivatives Implementation Group concluded, however, that a prepaid swap – at least under the structures analyzed in Issue No. A 9 – was a derivative.

<sup>96</sup> Released October 1999.

tion Group concluded that both structures considered qualified as derivatives:

Even though both structures involve a lending activity related to the prepayment of the fixed leg, the prepaid interest rate swap cannot be separated into a debt host contract and an embedded derivative because Statement 133 does not permit such bifurcation of a contract that, in its entirety, meets the definition of a derivative.<sup>97</sup>

The initial net investment in the example is \$600,000, which is smaller than an investment of \$25 million (the notional). Thus, "neither party is required to deliver an asset that is associated with the underlying or that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount) . . . ." <sup>98</sup> Thus, the swap in the example is a derivative under SFAS 133, and would be measured at fair value during the period of the contract.

A notional principal contract may itself be hedged. If so, some of the alternative tax accounting methods available for other notional principal contracts are not available.<sup>99</sup> If the hedging instrument is a cap or floor, the general rule of Treasury Regulation 1.446-3(f)(2)(iv) applies:

A payment to purchase or sell a cap or floor must be recognized over the term of the agreement by allocating it in accordance with the prices of a series of cash-settled option contracts that reflect the specified index and the notional principal amount.

---

<sup>97</sup> The second structure discussed in Issue A 9 was a structured note where the initial payment was equal to the principal amount, but because of the leverage involved, the contract was determined to be a derivative despite the language in SFAS 133 § 8, quoted in the text above, providing that a derivative would not require an initial net investment equal to the notional amount. Issue A 9 states: "When a contract involves leverage, its notional amount is effectively the stated notional amount times the multiplication factor that represents the leverage." The Issue notes that, as a result of the leverage, the initial investment is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, which is the criterion of SFAS 133 § 6(b).

<sup>98</sup> The specifics of the transaction in Implementation Issue No. A 9 are somewhat different than those in the regulatory example.

<sup>99</sup> Specifically unavailable are the alternative methods in Treasury Regulation §§ 1.446-3(f)(2)(iii) and (v) alternative methods for prepaid swaps and other nonperiodic swap payments, and alternative methods for caps and floors.

The option pricing agreed to between the parties will be respected. Straightline or accelerated amortization of a cap premium is generally not permitted.

*Example Eight.* On January 1, 2001, KanD Corp. sells three European-style (exercisable only on the termination date) put options on Eurodollar time deposits with a strike price of nine percent. The options have exercise dates on each January 1 of 2002, 2003, and 2004. KanD sells these put options to LyB Corp. If LIBOR exceeds nine percent on any of these dates, LyB can exercise the option and receive the excess of LIBOR over nine percent times \$25 million. KanD is a subsidiary of FinArk (from the previous example above), and these options reduce FinArk's risk on its cap agreements with EdCar. (FinArk receives payments on the swap when LIBOR exceeds nine percent, and KanD, a corporation related to FinArk for these purposes, makes payments to LyB when LIBOR exceeds nine percent. Both are based on notional principal amounts of \$25 million, so the two related corporations have controlled some of their floating rate liability.)

Under Treasury Regulation 1.446-4(g)(2), FinArk cannot use the alternative methods of Treasury Regulation 1.446-3(f)(2)(v) to amortize the cap premium. Rather, it must use the method described in Treasury Regulation 1.446-3(f)(2)(iv).<sup>100</sup> This restriction in the choice of methods does not apply to EdCar, which presumably here can use a method different from that required of FinArk.<sup>101</sup>

### C. Swaps Recharacterized As Loans

A swap with significant nonperiodic payments is treated for tax purposes as two separate transactions consisting of an on-market, level payment swap and a loan. The loan is accounted for by both parties to the contract independently of the swap. The time value of the loan is recognized as interest, but is not included in the net income or net deduction from the swap. This is, in other words, where a loan is determined to be embedded in a swap—another instance of tax bifurcation, to be contrasted with the general integration approach of Treasury Regulations 1.1275-6 and 1.988-5, discussed below. There is no definition of “significant” for purposes of determining when a swap will be bifurcated in this manner.<sup>102</sup>

<sup>100</sup> As demonstrated in note 99, *supra*.

<sup>101</sup> Treas. Reg. § 1.446-3(g)(6), Example (1)(c) (2000).

<sup>102</sup> See Priv. Ltr. Rul. 99-38-003 (May 27, 1999). An upfront payment (yield adjustment fee) based on the present value of 1% (9% of the present value of the fixed payments) of the notional amount (also \$100 million) was not significant

*Example Nine.* On January 1, 2000, MitchCo and NoncomCo enter into an interest rate swap under which NoncomCo will make five annual payments to MitchCo equal to LIBOR times a notional principal amount of \$100 million. In return, MitchCo will pay NoncomCo six percent of \$100 million annually, plus an upfront payment of \$15,163,147 on the date the contract is entered into. The rate for similar swap agreements based on LIBOR is ten percent, so the upfront payment is the present value of five payments of \$4 million ( $10\% - 6\% = 4\% \times \$100 \text{ million} = \$20 \text{ million}$ ).

The upfront payment of over \$15 million is deemed (by the writers of the examples in the regulations, in any case) to be significant when compared to the present value of the total fixed payments due under the contract. Thus, the transaction is recharacterized as consisting of an interest rate swap and a loan of \$15,163,147 from MitchCo to NoncomCo. NoncomCo is treated as repaying the loan in installments over the terms of the agreement, and MitchCo is treated as paying the installment payments on the loan back to NoncomCo as part of its fixed payment on the swap in exchange for the LIBOR payments by NoncomCo.

Assuming a constant yield to maturity and annual compounding at ten percent, MitchCo and NoncomCo account for the principal and interest on the loan as follows:

	Level payment	Interest component	Principal component
2001	\$4,000,000	\$1,516,315	\$ 2,483,685
2002	4,000,000	1,267,946	2,732,054
2003	4,000,000	994,741	3,005,259
2004	4,000,000	694,215	3,505,785
2005	4,000,000	363,636	3,636,364
	\$20,000,000	\$4,836,853	\$15,163,147

MitchCo claims interest income, and NoncomCo claims an interest deduction each tax year equal to the interest component of the deemed

---

in Treasury Regulation 1.446-3(g)(6), Example (2). But in Example (3) from the same section, 4% of the notional amount (66.7% of the present value of the fixed payments) was significant.

installment payments on the loan. These amounts are not included in the parties' net income or net deduction from the swap contract, but MitchCo recognizes interest income, and NoncomCo receives an interest deduction each tax year equal to the interest component of the deemed installment payments on the loan. The principal components are needed only to compute the interest component of the level payment, and do not otherwise affect the parties' net income or deductions under the contract.

NoncomCo makes swap payments based on LIBOR and receives fixed-rate payments equal to the sum of the stated fixed rate and the rate calculated by dividing the deemed level annual payments on the loan by the notional principal amount. Thus, the fixed rate on the swap is ten percent, which is the sum of the stated rate of six percent and the rate calculated by dividing the annual loan payment of \$4 million by the notional amount of \$100 million, or four percent. The swap payments from MitchCo to NoncomCo of \$10 million and the LIBOR-based payments from NoncomCo to MitchCo are included in the parties' net income or net deductions from the contract for each tax year. Assuming that LIBOR, as used to calculate the variable-rate payments, is as indicated in the second column below, the payments under the swap are as follows:

Year	LIBOR	N to M	M to N	Net payment
2001	10.50%	\$10,500,000	\$10,000,000	\$ 500,000
2002	11.00%	11,000,000	10,000,000	1,000,000
2003	10.10%	10,100,000	10,000,000	100,000
2004	9.50%	9,500,000	10,000,000	(500,000)
2005	9.40%	9,400,000	10,000,000	(600,000)

Thus, the separation of the embedded debt from the swap becomes a means of precluding either party from obtaining a tax advantage from the upfront payment. A specific instance of this approach arises where the party making variable-rate payments enters into another, perhaps offsetting contract, under which it receives LIBOR and obtains another upfront payment.

The treatment of the transaction under SFAS 133 follows that for the previous set of examples as analyzed in Implementation Issue No. A 9. Thus, the transaction is a single derivative for financial accounting purposes.

*Example Ten.* Continuing the facts of the prior example, on January 1, 2001, NoncomCo also enters into an interest rate swap with OrioD

Corp. Under this five-year swap, NoncomCo must make annual payments at 12 percent and OrioD must make annual payments at LIBOR, both on a notional amount of \$100 million. The rate for similar swap agreements is, as noted previously, ten percent. To compensate for the difference, OrioD pays NoncomCo an upfront yield adjustment fee of \$7,581,574, which equals the present value, at ten percent compounded annually, of five annual payments of \$2 million (2% of \$100 million). Combined with the transaction with MitchCo, NoncomCo has effectively borrowed \$22,744,721 (\$15,163,147 + \$7,581,574). If these positions were entered into to avoid interest characterization on a net loan position, the IRS may recharacterize the swaps as a loan which NoncomCo will repay in five annual installments of \$6 million each.<sup>103</sup> Under this treatment, NoncomCo has no notional principal contract income or expense, though this recharacterization has no effect on the treatment given the contracts by MitchCo and OrioD. This integration of two notional principal contracts to create a single synthetic debt instrument (as to one party to the transactions) is similar to the integration approach of Treasury Regulation 1.1275-6, discussed below.<sup>104</sup>

If a mark-to-market system similar to that contained in SFAS 133 were used as the basis of the tax system, this kind of integration ability would be essential for the IRS to preclude taxpayers from using separate structures to accomplish what integrated structures would not allow. Since SFAS 133 is, in significant part, a bifurcation system, these kinds of safeguards are not required of its structure (and not as essential for its financial accounting purposes).

---

<sup>103</sup> Treasury Regulation § 1.446-3(g)(2) (2000): “where such positions [reducing risk on a notional principal contract with another such contract, a future, forward, option, or other financial contract other than a debt instrument] are entered into to avoid the appropriate timing or character of income from the contracts taken together, the Commissioner may require that amounts paid to or received by the taxpayer under the notional principal contract be treated in a manner that is consistent with the economic substance of the transaction as a whole.” There is also a general anti-abuse rule in Treasury Regulation § 1.446-3(i), allowing the IRS to depart from the rules “as necessary to reflect the appropriate timing of income and deductions from the transaction.” Treas. Reg. § 1.446-3(i) (2000).

<sup>104</sup> Treas. Reg. § 1.446-3(g)(6), Example (4) (2000).

*D. Regulated Futures Contracts*

Section 1256 provides a mark-to-market system for regulated futures contracts, which include exchange-traded futures, foreign currency contracts, listed nonequity options,<sup>105</sup> or dealer equity options.<sup>106</sup> Under the mark-to-market system of Section 1256(a), a “section 1256 contract” is marked to market on the last business day of each tax year, and any gain or loss on the contract is treated as 40 percent short-term capital gain or loss, and 60 percent long-term capital gain or loss.<sup>107</sup> Not all Section 1256 contracts receive this 60/40 capital treatment, since Section 1256(f)(2) provides that Section 1256(a)(3) does not apply to any gain or loss which, but for that section, would be ordinary. Section 1256(e) excepts hedging transactions from the capital treatment of Section 1256(a). To assure that ordinary treatment for hedging transactions does not create any interpretive conflicts with Section 1221, the Taxpayer Relief Act of 1999 added Section 1221(a)(7) specifying that properly identified hedging transactions are an exception to the definition of capital asset.<sup>108</sup> Section 1256(e), in defining “hedging transaction,” now contains a cross reference to Section 1221(b)(2), which provides that such a transaction is one entered into by the taxpayer in the normal course of its trade or business to manage specified risks. As with other hedging opportunities under the Code, the hedging transaction must be identified as such before the close of the day on which it was entered into.<sup>109</sup>

In enacting Section 1256 in 1981, Congress apparently assumed that hedging contracts that were “an integral part of the taxpayer’s business, such as farming or food processing,” would be ordinary because of

---

<sup>105</sup> Excluding options to buy or sell stock or options based on an index where the Commodities Futures Trading Commission has not designated a market. 26 U.S.C. § 1256 (1994).

<sup>106</sup> So that Section 1256 applies traded equity options for any dealer. *Id.*

<sup>107</sup> 26 U.S.C. § 1256(a)(3) (1994).

<sup>108</sup> Legislative history of the 1999 modification of the definition of hedging contains the statement: “As under the present-law Treasury regulations, the transaction must be identified as a hedge of specified property. It is intended that this be the exclusive means through which the gains or losses with respect to a hedging transaction are treated as ordinary.” S. REP. No. 106-120, at 196 (1999).

<sup>109</sup> 26 U.S.C. § 1256(e)(2) (1994); Treas. Reg. § 1.1256(e)-1 (2000). For other hedging transaction identification requirements, see, for instance, Treas. Reg. § 1.1221-2(e) (2000), Treas. Reg. § 1.1275-6(e) (2000), Treas. Reg. § 1.988-5(a)(8) (2000) and Treas. Reg. § 1.954-2(a)(4)(ii)(B) (2000).

the Supreme Court's decision in *Corn Products*.<sup>110</sup> In amending Section 988 in 1988, Congress noted that *Arkansas Best Corp.* had "narrowed the classes of transactions generally thought to be eligible for the section 1256(e) exception from mark-to-market treatment." As a result, for Section 988 contracts, Congress made it clear that a Section 988 contract can receive ordinary treatment, yet still be covered by Section 1256:

The bill [enacted as PL 100-647] eliminates the 1256 carve-out; that is, the bill provides that a forward contract, futures contract, option, or similar financial instrument that is subject to the section 1256 mark-to-market rule is nevertheless also a section 988 transaction, assuming that the instrument otherwise meets the section 988 transaction definition . . . . Except for the capital gain and loss rules of section 1256(a)(3), section 1256 will continue to apply to such contracts (see sec. 1256(f)(2)).

With the Tax Relief Extension Act of 1999 Congress has added three exceptions to the capital treatment—commodities derivatives financial instruments held by commodities derivatives dealers, hedging transactions, and "supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer."

The Finance Committee Report<sup>111</sup> explains:

Finally, because hedging status under present law is dependent upon the ordinary character of the property being hedged, an issue arises with respect to hedges of certain supplies, sales of which could give rise to capital gain, but which are generally consumed in the ordinary course of a taxpayer's trade or business and that would give rise to ordinary deductions. For purposes of defining a hedging transaction, Treasury regulations treat such supplies as ordinary property. [Treasury Regulation 1.1221-2(c)(5)(ii)] The Committee believes that it is appropriate to confirm this treatment by specifying that such supplies are ordinary assets.

---

<sup>110</sup> S. REP. NO. 97-144, at 156 (1981), 1981-2 CB 468, n. 4. The note states that commodity futures are not inventory, though they are an integral part of the taxpayer's business, and therefore cannot be capital. As discussed below, the interpretation of *Corn Products Refining Company v. Commissioner of Internal Revenue*, 350 U.S. 46 (1955), was incorrect, if viewed from the perspective later added by *Arkansas Best Corp. v. Commissioner of Internal Revenue*, 485 U.S. 212 (1988).

<sup>111</sup> S. REP. 106-201, at 26 (1999), 999 TNT 208-6.

This is not so broad as to include all Section 1231 property, but is broader than the cited regulation, which only refers to noninventory supplies. A noninventory supply is defined as one “the taxpayer purchases for consumption in its trade or business . . . .” If the taxpayer sells “only a negligible amount of a noninventory supply”—or, presumably, none at all—then “for purposes of determining whether a transaction to hedge the purchase of that noninventory supply is a hedging transaction, the supply is treated as ordinary property.”

The Service indicated in 1992 or 1993 advice to the field that:

Congress’s failure after *Arkansas Best* to enact legislation clarifying that all section 1256(e) hedges are ordinary supports the view that all section 1256(e) hedges are capital except for foreign currency hedges covered by section 988 and hedges like those involved in *Corn Products* that give the holder the right to acquire property that would be within one of the exceptions [to capital asset treatment] in the holder’s hands.<sup>112</sup>

Must hedges be ordinary after the addition of Section 1221(a)(7)? It appears so. Though Section 1256(e) is still entitled “Mark to market not to apply to hedging transactions,” the cross-reference in Section 1256(e)(2) to Section 1221(b)(2) is comprehensive. That provision refers to “any transaction entered into by the taxpayer in the normal course of the taxpayer’s trade or business” for the specified risk management purposes (which can be expanded by regulation). Section 1221 specifies that “any” properly identified hedging transaction is an exception to capital asset treatment.

If a taxpayer has “at any time” identified personal property as part of a hedging transaction, Section 1256(f)(1) provides that gain on such property “shall in no event be considered as gain from the sale or exchange of a capital asset.”<sup>113</sup> Thus, a taxpayer cannot remove the hedge in order to obtain capital gain treatment when, if the hedge were in place, disposition of the property would produce ordinary income. A loss, however, is not reclassified as ordinary under this provision.

---

<sup>112</sup> Field Service Advice 19991130 (May 25, 1999) (from Assistant Chief Counsel Daniel J. Wiles, Financial Institutions and Products Field Service Division). The dating is based on a reference in the advice to “the over four years since *Arkansas Best*.” *Arkansas Best* was decided in 1988. The advice concludes that “it is clear that the hedging exemption of Section 1256(e) does not provide character rules.” *Id.*

<sup>113</sup> Personal property, for this purpose, is defined in 26 U.S.C. § 1092(d)(1) (1994).

Section 1256(f)(3)(A) deals with traders in Section 1256 contracts and indicates that gain or loss on trading in such contracts produces capital gain or loss.<sup>114</sup> However, an exception is provided where a Section 1256 contract is held to hedge property "if any loss with respect to such property in the taxpayer would be ordinary loss." The problem is that Section 1256(f)(3)(B) does not say what provision applies if Section 1256(f)(3)(A) does not apply, and the language was not amended by the Tax Relief Extension Act of 1999. Presumably, as the Service has indicated in technical advice, the general rules of Section 1221 come into play.<sup>115</sup> That would make the provision nearly meaningless, since ordinary treatment of the hedged item would be necessary for hedging transaction treatment now.

Futures were marked to market for financial accounting purposes even before SFAS 133,<sup>116</sup> and the tax and financial accounting treatments here are closer than with other financial instruments.

#### *E. Debt Instruments*

Under the general timing rules of Treasury Regulation 1.446-4(e)(4), a hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate must generally be accounted for under constant yield principles.

Thus, assuming that a fixed rate or qualified floating rate remains outstanding, hedging gain or loss is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. For example, gain or loss realized on a transaction that hedged an anticipated fixed rate borrowing for its entire term is accounted for . . . as if it decreased the issue price of the debt instrument.<sup>117</sup>

The Regulation also states that a hedge of a contingent payment of a debt instrument issued for nonpublicly traded property would be taken into account when the contingent payment itself is taken into account.

---

<sup>114</sup> For the Service's perspective on how traders are distinguishable from investors, see Field Service Advice 199947006 (Nov. 26, 1999) (advice memo to the field from Jeffrey Dorfman, August 9, 1999).

<sup>115</sup> *Id.*

<sup>116</sup> SFAS 80, Accounting for Futures Contracts.

<sup>117</sup> See Treasury Regulation § 1.446-4(e)(8) regarding recognition of gain or loss on a hedging transaction to reduce risk on a debt issuance or obligation if the hedged transaction is not consummated. Treas. Reg. § 1.446-4(e)(8) (2000).

If a cap or floor is entered into primarily to reduce risk on a debt instrument or group of such instruments held or issued by a taxpayer, the taxpayer may amortize a payment to purchase or sell the cap or floor under one of two methods specified in Treasury Regulation 1.446-3(f)(2)(v), as opposed to using the general method for swaps described above.<sup>118</sup> These methods are not available for caps or floors entered into or acquired by a dealer in notional principal contracts in its capacity as a dealer. If a premium is paid upfront for a cap or floor, the level payment method may be used. If the nonperiodic payments on a cap or floor are not made upfront, they may be amortized by treating the contract as if it provided for a single upfront payment equal to the present value of the nonperiodic payments and a loan between the parties.<sup>119</sup>

*Example Eleven.* On January 1, 2001, LIBOR is eight percent and FinArk pays EdCar \$600,000 for a contract obligating EdCar to make a payment to FinArk each quarter equal to one-fourth of the excess, if any, of three-month LIBOR over nine percent on a notional amount of \$25 million. Both EdCar and FinArk are calendar year taxpayers.<sup>120</sup> FinArk elects to amortize the cap premium using the alternative level payment method provided in Treasury Regulation 1.446-3(f)(2)(v)(A) because FinArk has entered into the swap to reduce its risk on a floating rate debt it has issued. FinArk, therefore, amortizes the cap premium by assuming that the \$600,000 is repaid in three equal annual installments, assuming a discount rate of ten percent. Each payment is divided into a time value component and a principal component:

	Level payment	Time value component	Principal component
2001	\$241,269	\$ 60,000	\$181,269
2002	241,269	41,873	199,396
2003	241,269	21,934	219,335
Total	723,807	123,807	600,000

The net of the ratable daily portions of the principal component and the LIBOR-based payments received from EdCar comprise FinArk's an-

<sup>118</sup> See discussion of Treasury Regulation § 1.446-3(f)(2)(ii), *supra* note 90.

<sup>119</sup> This method cannot be used where a derivative or other financial instrument is being used to hedge a notional principal contract. Treas. Reg. § 1.446-3(g)(2) (2000).

<sup>120</sup> Treas. Reg. § 1.446-3(f)(4), Example (3) (2000).

nual net income or deduction from the cap. The time value components are used to determine the ratable daily portions of the cap premium, but are otherwise disregarded. Thus, if three-month LIBOR, is ten percent throughout 2001, nine point five percent throughout 2002, and nine percent throughout 2003, the net income and deductions for each year is as follows:

	Cap allocation	E to F	Net
2001	\$181,269	\$62,500	\$118,769
2002	199,296	31,250	168,046
2003	219,335	0	219,335

Since the premium on the cap is amortized in the same manner as if it were a loan (with the interest component ultimately disregarded), the amortization will to some extent correlate with the income or expense on a loan, which explains the function of this specific alternative method.

Again, the financial accounting treatment follows that outlined for the examples in the discussion of notional principal contracts.

#### *F. Contingent Payment Debt Instruments*

Debt instruments with one or more contingent payments (generally called structured notes in the financial world) are accounted for under the noncontingent bond method if they are issued for money or publicly traded property, or under a method specified in Treasury Regulation 1.1275-4(c) (which, unfortunately, has no name specified in the regulation) if they are issued for nonpublicly traded property. A number of transactions are not accounted for under the contingent payment debt regulations, including debt instruments where the payment schedule may be altered based on a contingency, and where the altered payment schedule is known on the issue date of the debt instrument.<sup>121</sup> A debt instrument is not contingent merely because it contains an option to convert the instrument into stock of the issuer or into an amount equal to the approximate value of such stock.<sup>122</sup>

<sup>121</sup> Treas. Reg. § 1.1272-1(c) (2000). A payment schedule that is significantly more likely than not to occur determines the yield and maturity of the debt instrument. Treas. Reg. § 1.1272-1(c)(2) (2000).

<sup>122</sup> Or into debt of a related party or a cash amount approximately equal to such debt. Treas. Reg. § 1.1275-4(a)(4) (2000).

### 1. Noncontingent Bond Method

The noncontingent bond method is an accrual method, determining the interest accrued in a tax year by constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing OID on a noncontingent debt instrument. If the accrual amount differs from the projected amount, an adjustment is made. The method requires four steps:

1. Comparable yield as of the debt instrument's issue date is determined.
2. The projected payment schedule as of the issue date is then determined. The issuer's projected payment schedule is used to determine the holder's interest accruals and adjustments.<sup>123</sup> This schedule remains fixed throughout the term of the debt instrument, except where the payment is fixed more than six months before it is due, in which case the payment schedule is modified prospectively.<sup>124</sup>
3. The daily portions of interest for a tax year are determined by multiplying the comparable yield of the instrument for the accrual period times its adjusted issue price at the beginning of that period, with the result allocated to each day in the accrual period.
4. The amount of income or deductions for differences between the projected and actual contingent payments are adjusted.

The comparable yield and projected payment schedule must be supported by contemporaneous documentation showing that both are reasonable and made in good faith.<sup>125</sup> The comparable yield is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument. If a Treasury Regulation 1.1275-6 hedge is available, the comparable yield is the yield on the synthetic fixed rate debt instrument that would result if the issuer entered into the Treasury Regulation 1.1275-6 hedge. No adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. The comparable yield must not be less than the applicable Federal rate. Where contingent payments are not based on market information, the comparable yield is presumed to be the applicable

---

<sup>123</sup> Treas. Reg. § 1.1275-4(b)(4)(iv) (2000).

<sup>124</sup> Treas. Reg. § 1.1275-4(b)(9)(ii)(A) (2000).

<sup>125</sup> Treas. Reg. § 1.1275-4(b)(4) (2000).

Federal rate. No amounts payable on a debt instrument under the non-contingent bond method are qualified stated interest.

The projected payment schedule includes each noncontingent payment and an amount for each contingent payment.<sup>126</sup> If a contingent payment is based on market information, the amount of the projected payment is the forward price of the contingent payment. If the right to a contingent payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option—i.e., the option premium—compounded at the applicable Federal rate from the issue date to the date the contingent payment is due.

*Example Twelve.* On December 31, 2000, Xanadu Corp. issues for \$1 million a debt instrument maturing on December 31, 2010. The instrument provides for annual payments of interest at the rate of six percent, and a payment at maturity equal to \$1 million plus the excess, if any, of the price of 10,000 shares of publicly traded stock in ProCo over \$350,000, or less the excess, if any of \$350,000 over the price of 10,000 shares of stock in ProCo. On the issue date, the forward price of 10,000 shares of ProCo on December 31, 2010, is \$350,000.

The instrument's comparable yield is the yield on the synthetic debt instrument that would result if Xanadu entered into a Treasury Regulation 1.1275-6 hedge, which would be a forward contract to purchase 10,000 shares of stock on December 31, 2010. The resulting synthetic debt instrument would yield six percent, compounded annually, which is, therefore, the comparable yield.

The projected payment schedule consists of ten annual payments of \$60,000, and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is the forward price of the payment. Because the forward price to purchase 10,000 shares of ProCo is \$350,000, the projected amount of the contingent payment at maturity is \$1 million, consisting of the \$1 million base amount and no additional amount to be paid or received under the forward.

If alternatively, the forward price to purchase 10,000 shares of stock on December 31, 2010, is \$370,000, the resulting synthetic hedge would yield 6.5 percent compounded annually, which would become the comparable yield on the debt instrument.<sup>127</sup> The projected payment sched-

---

<sup>126</sup> Treas. Reg. § 1.1275-4(b)(4)(ii) (2000).

<sup>127</sup> This ability to alter the comparable yield based on the contingency becomes a significant aspect of the tax advantage of certain instruments, such as PHONES, marketed to exempt taxpayers. See David S. Miller & John Ensminger, *The Federal Income Tax Treatment of Exchangeable Debt and PHONES*, 13 J. BANK

ule would consist of ten annual payments of \$60,000 and a projected contingent payment at maturity of \$1,020,000.<sup>128</sup>

Under SFAS 133, the transaction involves an upfront payment equal to the notional of the contract, and is, therefore, not a derivative in its totality. The next question is whether the debt contains an embedded derivative. The embedded forward meets the definition of a derivative in SFAS 133 ¶ 6 for a derivative. For financial accounting purposes, therefore, the contingent payment debt instrument would be bifurcated into a fixed rate six percent debt instrument and a cash-settled forward for 10,000 shares of ProCo stock. Since the forward could not be highly effective in hedging the debt, there is no hedging relationship and the forward, but not the debt, would be marked to market.

Under Treasury Regulation 1.1275-4(b)(iii), if a taxpayer has an unconditional option to put or call a debt instrument or exchange it for other property, or extend its maturity date, the projected payment schedule is determined under the principles of Treasury Regulation 1.1272-1(c)(5). This means that an issuer is deemed to exercise or not exercise an option in a manner that minimizes the yield on the debt instrument, and the holder is deemed to do the same in a manner that maximizes the yield.

For financial accounting, calls or puts that can accelerate the repayment of principal on a debt instrument are generally considered to be clearly and closely related to a debt instrument and, therefore, not separated from it.<sup>129</sup> Under ¶ 60(g):

An embedded derivative provision that either (1) unilaterally enables one party to extend significantly the remaining term to maturity or (2) automatically extends significantly the remaining term triggered by specific events or conditions is not clearly and closely related to the interest rate on a debt instrument unless the interest rate is concurrently reset to the approximate current market rate for the extended term and the debt instrument initially involved no significant discount. Thus, if there is no reset of interest rates, the embedded derivative must be separated from the host contract and accounted for as a derivative instrument.

---

TAX., Summer 2000, at 155.

<sup>128</sup> Treas. Reg. § 1.1275-4(b)(4)(vi), Example (1)(iii)(A) (2000).

<sup>129</sup> SFAS 133 § 60(d).

If a debt instrument is convertible into a specified number of shares of the debtor's or another entity's common stock, the conversion option is separated from the debt host contract and accounted for as a derivative instrument "provided that the conversion option would, as a freestanding instrument, be a derivative instrument subject to the requirements of this Statement."<sup>130</sup> Thus, an embedded option allowing the issuer to call or the holder to put a debt instrument would generally be clearly and closely related to it. An option to extend a debt instrument would be clearly and closely related if it were reset to market rate at the time of extension.

## 2. Debt Instruments Not Subject to Noncontingent Bond Method

For debt instruments issued for nonpublicly traded property, the contingent and noncontingent payments are separated and accounted for separately—another instance of tax bifurcation. The noncontingent payments have no qualified stated interest and are treated under the OID rules. The portion of a contingent payment treated as interest is includible in gross income by the holder and deductible from gross income by the issuer in their respective tax years in which the payment is made.<sup>131</sup>

### G. Variable Rate Debt Instruments

Variable rate debt instruments need not involve any embedded instruments since they often involve floating rates. Under Treasury Regulation 1.1275-5(a)(3), the instrument must not provide for any stated interest other than one or more "qualified" floating rates, a fixed rate and one or more qualified floating rates, a single "objective" rate, or a single fixed rate and a single objective rate that is a qualified inverse floating rate. A variable rate is a qualified floating rate if variation in the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated. A variable rate is not a qualified floating rate if it is subject to a cap, floor, governor (a restriction or restrictions on the amount of increase or decrease in the stated interest rate), or "other similar restric-

---

<sup>130</sup> SFAS 133 § 60(k).

<sup>131</sup> Treas. Reg. § 1.1275-4(c)(4)(i) (2000). Special rules determine the portions of contingent payments treated as principal and interest. The examples in the regulations give rent as an example of the contingent payment. Rents and royalties are not derivatives under SFAS 133, and would not be separated from the overall debt instrument on that basis. *Id.*

tions.”<sup>132</sup> Despite these restrictions, a limited set of caps, floors and governors can be embedded in a variable rate debt instrument:

1. A cap, floor or governor fixed throughout the term of the debt instrument.
2. A cap not reasonably expected on the issue date to cause the yield on the debt instrument to be significantly less than the expected yield without the cap.
3. A floor not reasonably expected on the issue date to cause the yield on the debt instrument to be significantly more than the expected yield without the floor.
4. A governor not reasonably expected to cause the yield to be either significantly more or significantly less than expected without it.<sup>133</sup>

If the embedded instrument does not fit within this narrow set of possibilities, the instrument is treated as a contingent payment debt instrument.<sup>134</sup>

Under SFAS 133 ¶ 61(f), floors, caps and collars on interest rates of debt instruments are considered clearly and closely related to the instrument, provided a cap is at or above the current market rate, or a floor is at or below the current market rate of the debt instrument at issuance. A derivative embedded in a variable rate debt instrument that has a floor on the interest rate (a floor option) would not be separated from the host contract and accounted for separately even though, in a falling interest rate environment, the debt instrument may have a return to the investor that is a significant amount above the market return of a debt instrument without the floor provision. There might be some discrepancy between tax and financial accounting treatment where the changing interest rate environment changes expectations at issuance. Nevertheless, it appears that a variable rate debt instrument with an embedded cap or floor that is significantly out of the money generally would not be bifurcated for financial accounting purposes.

#### *H. Synthetic Debt Transactions*

Certain hedges of debt instruments require that the hedge and the

---

<sup>132</sup> Treas. Reg. § 1.1275-5(b)(3) (2000).

<sup>133</sup> See description of a ratchet floater at SFAS 133 § 182, which will generally be considered clearly and closely related to the host.

<sup>134</sup> Treas. Reg. § 1.1275-5(a)(1) (2000).

debt<sup>135</sup> be integrated into a synthetic debt transaction, and taxed in this combined fashion. More specifically, if a financial instrument (a Section 1.1275-6 hedge) can be combined with a debt instrument<sup>136</sup> such that together their combined cash flows permit the calculation of a yield to maturity or such that together they could form a variable rate debt instrument under Treasury Regulation 1.1275-5,<sup>137</sup> then the two transactions are integrated and generally treated as a single synthetic debt instrument.<sup>138</sup> A financial instrument that can accomplish such hedging is "a spot, forward, or futures contract, an option, a notional principal contract, a debt instrument, or a similar instrument, or a combination or series of financial instruments."<sup>139</sup> Thus, any derivative or anything that behaves like one can be a Section 1.1275-6 hedge. Stock, however, cannot be used to hedge a debt under this provision.

If a transaction is integrated under Treasury Regulation 1.1275-6, the resulting synthetic debt instrument will generally be subject to the OID rules of Sections 163(e) and 1271 through 1275. Also, the synthetic debt can be part of a straddle, and interest payments on the transaction may, therefore, be capitalized under Section 263(g).<sup>140</sup> The stated redemption price at maturity of the synthetic debt instrument consists of the sum of all amounts paid on the qualifying debt instrument and the hedge transaction, reduced by any amounts received on the hedge.<sup>141</sup> A corollary of this approach is that no amounts payable on the synthetic debt are qualified stated interest.<sup>142</sup>

---

<sup>135</sup> A qualifying debt instrument receiving this integrated treatment does not include (1) tax-exempt obligations under 26 U.S.C. § 1275(a)(3), (2) (1994) interests and mortgages held by REMICs, and certain similar instruments, or (3) contingent payment debt instruments subject to Treasury Regulation §§ 1.483-4 or § 1.1275-4(c).

<sup>136</sup> The hedge cannot be of currency risk. Treas. Reg. § 1.1275-6(b)(2) (2000).

<sup>137</sup> The requirement of that Regulation that interest payments be stated as interest does not apply.

<sup>138</sup> The two transactions will not be integrated for certain purposes, such as when a foreign person enters into integrated transactions giving rise to U.S.-source income that is not effectively connected with a U.S. trade or business. In such a case, Sections 871(a), 881, 1441, 1442, and 6049 are applied to the individual transactions on a separate basis. Treas. Reg. § 1.1275-6(f)(12) (2000).

<sup>139</sup> Treas. Reg. § 1.1275-6(b)(3) (2000).

<sup>140</sup> Treas. Reg. § 1.1275-6(f)(1) (2000).

<sup>141</sup> Treas. Reg. §§ 1.1275-6(f)(7)(i) and (ii) (2000).

<sup>142</sup> Treas. Reg. § 1.1275-6(f)(6) (2000). Qualified stated interest is defined in Treasury Regulation § 1.1273-1(c) (2000).

*Example Thirteen.* On January 1, 2000, Visco, a domestic corporation, issues a five-year debt instrument for \$10,000, which provides for annual payments of interest at a rate equal to the value of one-year LIBOR and a principal payment of \$10,000 at maturity. On the same day, Visco enters into a five-year interest rate swap with an unrelated party under which Visco pays six percent and receives one-year LIBOR on a notional amount of \$10,000. The payments on the swap are made on the same days as the payments on the debt. Visco identifies the debt instrument and the swap as an integrated transaction.

The debt instrument is a qualifying debt instrument and the swap is a Section 1.1275-6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. The synthetic debt instrument thus created has an issue price of \$10,000 and provides for annual interest payments of \$600 and a principal payment of \$10,000 at maturity. Since no amounts payable on the synthetic debt instrument can be qualified stated interest, the synthetic debt instrument has a stated redemption price at maturity of \$13,000, and, therefore, has \$3,000 of OID.<sup>143</sup>

The authors of the regulations provided an ambitious policy reason for such integrated treatment:

The purpose of this section is to permit a more appropriate determination of the character and timing of income, deductions, gains, or losses than would be permitted by separate treatment of the components.<sup>144</sup>

This is a conceptual divergence from the approach taken by the FASB, which clearly believed that “more appropriate” determinations could be made by bifurcation. Thus, for financial accounting purposes, the transactions would be reported separately.

There must be substantial overlap as to the terms of the two instruments that are integrated to form the synthetic debt (at least as to the period of integration). Under Treasury Regulation 1.1275-6(b)(2), a financial instrument is not a Treasury Regulation 1.1275-6 hedge if the resulting synthetic debt instrument does not have the same term as the remaining term of the qualifying debt instrument.<sup>145</sup> If the debt instrument (or another debt instrument that was part of the same issue) was previously part of another integrated transaction, or if the hedge was

---

<sup>143</sup> Treas. Reg. § 1.1275-6(h), Example (1) (2000).

<sup>144</sup> Treas. Reg. § 1.1275-6(a) (2000).

<sup>145</sup> Which does not necessarily require that the hedge have the same term. See Rev. Rul. 00-12, 2000-11 I.R.B. 1 and discussion in text *infra*.

part of such a transaction, this precludes integration if the prior integrated transaction was terminated, or legged out of, within 30 days immediately preceding the date that would be considered the issue date of the synthetic debt instrument.<sup>146</sup> Neither instrument can have been part of a straddle prior to the issue of the synthetic debt instrument. There is no time limit as to this part-of-a-straddle limitation.

If the hedge is itself a debt instrument, it can be a Treasury Regulation 1.1275-6 hedge only if it is issued substantially contemporaneously with, and has the same maturity (including rights to accelerate or delay) as the hedged debt. A debt instrument issued by a taxpayer and another held by the taxpayer cannot be part of the same integrated transaction.

*Example Fourteen.* ZedaCo issues two ten-year debt instruments. The first instrument has an issue price of \$1 million and pays annual interest at six percent and, at maturity, pays \$1 million increased by \$1,000 times the increase in the value of the S&P 500 Index over the term of the instrument, or reduced by \$1,000 times the decrease in the value of that Index over the term. The amount paid at maturity may not be less than \$500,000 or more than \$1.5 million. The second debt instrument also has an issue price of \$1 million, but pays interest annually at eight percent and, at maturity, is reduced by \$1,000 times the increase, if any, in the S&P 500 Index over the term of the instrument, or increased by \$1,000 times the increase, if any, in the value of the S&P 500 Index over the term of the instrument. The amount paid at maturity on this instrument may also not be less than \$500,000 or more than \$1.5 million.

ZedaCo identifies the first debt instrument as a qualifying debt instrument and the second as a Section 1.1275-6 hedge and satisfies the requirements for treating the two instruments as an integrated transaction. The synthetic debt instrument has an issue price of \$2 million, providing for a payment at maturity of the same amount, with annual payments of \$140,000. Since no amounts payable on the synthetic debt instrument are qualified stated interest, the instrument's stated redemption price at maturity is \$3.4 million, giving it \$1.4 million of OID.

Under SFAS 133, each of the transactions would most probably be bifurcated into straight debt and an index future on which there is a put and a call. The futures, being correlated with equity indices, would not be clearly and closely related to the host contracts and would be separated from them for separate accounting. The debt instruments would not be hedged by the embedded contracts and would not be marked to market absent a general fair value regime for financial instruments.

---

<sup>146</sup> The IRS can ignore this requirement and integrate two transactions under certain circumstances. Treas. Reg. § 1.1275-6(c)(2)(iv) (2000).

The taxpayer seeking integrated treatment must identify the transactions on or before the date the taxpayer enters into the hedge. None of the parties to the hedge can be related under Section 267(b) or 707(b)(1) unless the party providing the hedge uses a mark-to-market method of accounting for the hedge and similar transactions. Thus, the related party's ability to benefit from providing a means of altering the treatment of a debt is limited. If the taxpayer is a foreign person, both the debt and the hedge must be effectively connected with a U.S. trade or business throughout the term of the qualifying debt instrument.

The Service can integrate a debt and a financial instrument if the combined cash flows "are substantially the same as the combined cash flows required for the financial instrument to be a § 1.1275-6 hedge." This authority is given the Service only if the debt instrument is a contingent payment debt instrument under Treasury Regulation 1.1275-4 or a variable rate debt instrument under Treasury Regulation 1.1275-5, and pays interest at an objective rate (i.e., not a qualified floating rate).<sup>147</sup> This is not labeled an anti-abuse provision, but clearly operates as one. For instance, a taxpayer may not integrate a transaction if it has, as noted above, legged out of another integrated transaction within the prior 30 days. If, however, the taxpayer enters into a new hedge with the same debt instrument (or another instrument that is part of the same issue), the Service can impose integration.

### *I. Debt Straddles*

In Rev. Rul. 2000-12, 2000-11 IRB 1, the Service determined that the integration rules of Treasury Regulation 1.1275-6 allowed the Service to eliminate the appeal of debt straddles, known to dealers as bear/bull notes.<sup>148</sup>

*Example Fifteen.* On September 1, 2000, YabaCo, a calendar year taxpayer, purchases two privately placed debt instruments from unrelated issuers at \$ million each. Note one has a ten-year term and a stated principal amount of \$1 million, provides for quarterly interest payments beginning December 1, 2000. The interest for the first quarter is 5.7 percent. This note also provides for contingent payments based on an event that will or will not occur on December 1, 2000, with a probability of 50 percent either way. This reset event does not depend on actively traded personal property—a provision, along with the private placement of the instruments, designed to avoid any application of the straddle rules. If the

---

<sup>147</sup> See Treas. Reg. § 1.1275-5(c) (2000).

<sup>148</sup> See discussion of some general issues regarding the straddle rules, *infra*.

reset even occurs, the interest rate doubles to 11.4 percent. If the reset event does not occur, the interest rate is reset at zero.

Also on September 1, 2000, YabaCo enters into another privately placed debt instrument, Note two, with the same terms as Note one except that the same reset event has the opposite consequence. If the event occurs, the interest rate is reset at zero; if it does not occur, the interest rate doubles to 11.4 percent.

Inevitably, one of these notes will increase in value while the other will decrease. On December 1, 2000, the reset even does not occur and Note two increases significantly in value while Note one decreases in value. On December 2, 2000, YabaCo sells Note one for its fair market value and claims a loss.

In Rev. Rul. 2000-12, the IRS takes the position that even before August 13, 1996, the effective date of Treasury Regulation 1.1275-6, the transaction is precluded under Treasury Regulation 1.165-1(b), which provides that “[o]nly a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.” The Service also cites a sampling of the case law on economic substance (e.g., *ACM Partnership*,<sup>149</sup> *Scully*,<sup>150</sup>) to bolster its conclusion that the transaction produces an “artificial loss” that is not allowable under Section 165.<sup>151</sup> In any case, for transactions entered into after the effective date of Treasury Regulation 1.1275-6, the Commissioner can integrate the two debt instruments to produce a synthetic debt instrument with a ten-year term, a stated principal amount of \$2 million, and interest at 5.7 percent, payable quarterly. Treasury Regulation 1.1275-6(f)(6) provides that no amounts payable on the synthetic debt instrument are qualified stated interest under Treasury Regulation 1.1273-1(c). The combined payments on the synthetic note would, therefore, be \$1,140,000 if held to maturity, which is original issue dis-

---

<sup>149</sup> *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998).

<sup>150</sup> *Scully v. United States*, 840 F.2d 478 (7th Cir. 1988).

<sup>151</sup> The Service relied on the economic substance argument in 1999 field service advice, Field Service Advice 200013011 (Mar. 31, 2000) (2000 TNT 64-65, Apr. 3, 2000), regarding a structure a prospectus called a “zero note” and a “super floater.” The reset events involved concerned whether LIBOR exceeded or failed to exceed a specified percent. A legal opinion letter attached to the prospectus concluded that the deal would not constitute a straddle because the notes were not listed on a securities exchange or quoted in an inter-dealer price quotation system. Neither the broker nor any potential purchaser was expected to prepare and retain price quotations on the notes on an ongoing basis. See Treas. Reg. § 1.1092(d)-1(b)(2)(i) (2000).

count. (\$57,000/year/note x 2 notes x 10 years).<sup>152</sup> The stated redemption price at maturity is \$3,140,000, the sum of the \$2 million payment at maturity and the OID.

When, on December 2, 2000, YabaCo sells Note one and Rev. Rul. 2000-12 indicates that this is a legging out of the integrated transaction. Legging out is defined in Treasury Regulation 1.1275-6(d)(2)(i)(A) as occurring when, prior to maturity of the synthetic debt instrument, the taxpayer disposes of all or part of the qualifying debt instrument or the Treasury Regulation 1.1275-6 hedge. When a taxpayer legs out of an integrated transaction, under Treasury Regulation 1.1275-6(d)(2)(ii)(B), immediately before the taxpayer legs out, it is generally treated as selling or otherwise terminating the synthetic debt instrument for its fair market value and any income, deduction, gain or loss is realized and recognized at that time. Thus, immediately before YabaCo sells the debt instrument whose interest rate has dropped to zero, it will be treated as selling the synthetic debt instrument that is the integrated transaction, recognizing gain or loss, depending on the change in market rates, and accrued OID. Since this occurs after the reset event, YabaCo is treated as entering into a transaction to sell Note one (which is now a sort of stripped bond), which should thus produce no gain or loss.

From a financial accounting perspective, the embedded derivative in this transaction can probably be extracted from the host contract. Under SFAS 133 ¶ 13 an embedded derivative instrument for which the underlying is an interest rate that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract is clearly and closely related to the host contract unless:

1. The hybrid instrument can contractually be settled in a such a way that the investor (holder) would not recover substantially all of its initial recorded investment.
2. The embedded derivative could at least double the investor's initial rate of return on the host contract and could also result in a rate of return that is at least twice what otherwise would be the market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

---

<sup>152</sup> Treasury Regulation § 1.1275-6(h), Example (6), also indicates that in a case like this, it is arbitrary which of the two debt instruments being integrated is to be considered the qualifying debt instrument, since both can be, and which is the hedge. Treas. Reg. § 1.1275-6(h), Example (6) (2000).

These factors are determined on the date the hybrid instrument is acquired.<sup>153</sup> Neither instrument would preclude the investor from recovering substantially all of its initial investment. However, either could result in doubling the rate of return and being at that point more than twice market rate. Therefore, the embedded instruments (something like knock-in and knock-out options) would probably be separated from the hosts. If the contracts do not meet the doubling rate of return threshold, they are clearly and closely related to the host instrument and do not need to be separated. If they meet this threshold, but valuation issues prevent them from being separated from the host contract, SFAS 133 ¶ 16 requires that the entire contract shall be measured at fair value with gain or loss recognized in earnings.<sup>154</sup>

The IRS also appears concerned that debt straddles may be created with terms sufficiently different as to each instrument that integration by the IRS may be precluded.

For example, NelCo purchases two privately-placed debt instruments on September 1, 2000, from unrelated issuers. Note three has a ten-year term and a stated principal amount of \$1 million, providing for quarterly interest payments at 5.7 percent. It also provides for contingent payments on an event that will occur on December 1, 2000, with a 50 percent probability. If this reset event occurs, the interest rate doubles to 11.4 percent. If it does not, the interest rate is reset to zero.

Note four is purchased for \$615,000 and has a 20-year term and a stated principal amount of \$615,000. It provides for quarterly payments at three-month LIBOR, but if the reset event—the same one that applies to Note three—occurs, the interest rate is reset at zero. If the event does not occur, the interest rate doubles to 200 percent of three-month LIBOR.

---

<sup>153</sup> SFAS 133 § 309 explains: “The test for separate accounting pursuant to paragraph 13 should be applied based on what is possible under the contractual terms and not on a probability basis.” SFAS 133 § 309. See Financial Accounting Standards Board, *Derivatives Implementation Group* Implementation Issue No. B 2 (Feb. 1999). If the interest rate for single-A rated debt increases to at least ten percent at the end of the second year of a structured note, the coupon rate on a ten-year note is reduced to zero and the investor must purchase an additional note from the issuer with a face amount of \$10 million, zero coupon, and a term of three and a half years. *Id.* The FASB staff concluded that the embedded derivative must be accounted for separately, since the return on the first note is reduced by the excess over fair value of the second. *Id.*

<sup>154</sup> In this case, the contract could not be treated as a hedging instrument for purposes of SFAS 133.

Again, the correlation between the two instruments revolves around the reset event, which creates the inevitable situation that one of the two instruments can be sold at a loss on December 2, 2000. Under Treasury Regulation 1.1275-6(b)(2)(ii)(B), a debt instrument can be a Treasury Regulation 1.1275-6 hedge only if it “has the same maturity (including rights to accelerate or delay payments) as, the qualifying debt instrument.” It is also uncertain whether the combined cash flows satisfy the requirements for producing a yield under Treasury Regulation 1.1275-6(b)(2)(i). Also, that Regulation specifies that a “financial instrument is not a § 1.1275-6 hedge . . . if the resulting synthetic debt instrument does not have the same term as the remaining term of the qualifying debt instrument.”

An anti-abuse rule, in the Service’s opinion, provides the solution. Treasury Regulation 1.1275-2(g)(2) provides:

If a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result.

Under Treasury Regulation 1.1275-2(g)(2), a result will not be unreasonable in the absence of an expected substantial effect on the present value of a taxpayer’s tax liability. A principal purpose of the Code in Sections 1271 through 1275 is to tax holders of debt instruments under the constant-yield method. “In this case,” the Ruling argues, “the transaction is structured to defeat this purpose by creating an artificial loss immediately after the reset.”

Thus, the Service concludes that it can integrate the two notes before one is sold (perhaps treating the instrument with the longer term as two separate instruments). Under the legging-out rules, NelCo is treated as disposing of the synthetic debt instrument for its fair market value and must realize and recognize any gain or loss on this deemed disposition.

This example may create a problem under the requirements of SFAS 133 for separating embedded instruments. If one of the two offsetting contracts meets the doubling of return threshold and one does not, one contract (the one meeting the threshold for separation) would be treated as two instruments, one of which is remeasured at fair value and one of which is not. The other contract would not be remeasured at fair value. If the contract that meets the requirement for separation cannot be separated because of valuation difficulties, the entire debt instrument would be remeasured. Since the doubling of return requirement could be fairly easily considered in the drafting of an instrument, some arbi-

trage seems possible here. In the end, the integration approach of the Internal Revenue Code seems preferable in this instance. This problem would go away if the FASB adopts a fair valuation system for all financial instruments.

### *J. Foreign Currency Transactions*

Under Section 988(d), if certain foreign currency transactions are part of a transaction entered into to reduce risk of currency fluctuations with respect to property held, borrowings made, or obligations incurred (or to be so held, made, or incurred) by a taxpayer, all the parts of the transaction will be considered a Section 988 hedging transaction, which will be integrated and treated as a single transaction. The foreign currency transactions that can receive this treatment are "Section 988 transactions," which are defined in Section 988(c) as:

1. Acquisition of a debt instrument or becoming the obligor under such an instrument (a "qualifying debt instrument").
2. Accruing any item of expense or gross income or receipts which is to be paid or received after the date of accrual.
3. Entering into or acquiring any forward, future, option, "or similar financial instrument."

The amount the taxpayer is entitled to receive or is required to pay must be denominated in terms of a nonfunctional currency or determined by reference to the value of one or more nonfunctional currencies. A transaction can be a Section 988 transaction without regard to whether it would otherwise be marked to market under Section 475 or Section 1256. When a transaction is determined to be a Section 988 transaction, Section 475, 1092, and 1256 do not apply to it.<sup>155</sup>

Under Section 988(a)(1)(B), a taxpayer can elect to treat any foreign currency gain or loss on a forward, future or option that is denominated in a nonfunctional currency (or determined by reference to one or more such currencies) as a capital asset. To make this election, the derivative must be a capital asset in the hands of the taxpayer, and cannot be part of a straddle.

---

<sup>155</sup> A debt instrument can be part of a straddle prior to being part of a qualified hedging transaction, at the discretion of the IRS. Treas. Reg. § 1.988-5(a)(7) (2000).

*K. Integration of Nonfunctional Currency Debt With Reg. 1.988-5 Hedge*

The regulations define a Section 1.988-5(a) hedge as a spot contract, future, forward, option, notional principal contract, currency swap, or similar financial instrument, or series or combination of such instruments, that when integrated with a qualifying debt instrument permit the calculation of a yield to maturity in the currency in which the synthetic debt instrument is denominated.<sup>156</sup> This obviously bears a close resemblance to the synthetic debt instruments that are created with from hedges of debt instruments in Treasury Regulation 1.1275-6 and, in fact, the yield to maturity on a 1.988-5(a) hedge is determined under the principles of Section 1272.<sup>157</sup> The stated redemption price at maturity on a debt is determined under Section 1273(a)(2) by reference to the amounts to be received under the hedge in exchange for the interest and principal payments received under the debt instrument.

*L. Hedged Executory Contracts*

Certain executory contracts can also be part of a Section 988 hedging transaction. Under Treasury Regulation 1.988-5(b)(2)(ii):

[A]n executory contract is an agreement entered into before the accrual date to pay nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the purchase of property used in the ordinary course of the taxpayer's business, or the acquisition of a service (or services) in the future, or to receive nonfunctional currency (or an amount determined with reference thereto) in the future with respect to the sale of property used or held for sale in the ordinary course of

---

<sup>156</sup> Treas. Reg. § 1.988-5(a)(4)(i) (2000). If an election is not made by the taxpayer to integrate such a derivative and a debt instrument, the IRS may do so under Treasury Regulation § 1.988-5(a)(8)(iii). Treas. Reg. § 1.988-5(a)(8)(iii) (2000). If there is no integration and the positions are offsetting positions in personal property, the straddle rules may apply. *Id.*

<sup>157</sup> See Treas. Reg. § 1.988-5(a)(9)(ii) (2000). Under Treasury Regulation § 1.988-5(a)(3)(ii), integration is possible even if only a portion of the debt instrument is hedged. That portion becomes the qualifying debt instrument. Treas. Reg. § 1.988-5(a)(3)(iii) (2000). No similar rule is available under Treasury Regulation § 1.1275-6. For a discussion of how legging in and legging out differ in Treasury Regulation §§ 1.1275-6 and 1.988-5(a) hedges, see Willard B. Taylor & Diana L. Wollman, *Why Can't We All Just Get Along: Finding Consistent Solutions to the Treatment of Derivatives and Other Problems*, 33 TAX LAW. 95 (1999).

the taxpayer's business, or the performance of a service (or services) in the future.

*Example Sixteen.* DenCo's functional currency is the U.S. dollar.<sup>158</sup> Zorba Co.'s functional currency is the Deutsche mark (DM). On January 1, 2001, DenCo and Zorba agree that DenCo will license Zorba certain technology to manufacture a new network communication system that only Zorba will be able to distribute in Germany. Zorba will pay DenCo DM 1 million for each system sold by April 1, 2002, and DenCo expects Zorba to sell three units by that date. Also, on January 1, 2001, DenCo enters into a forward contract to sell DM 3 million on April 30, 2002, at a price equal to \$0.6057 per Deutsche mark. DenCo designates the forward as a hedge of the risk of changes in its functional-currency-equivalent cash flows attributable to changes in the Deutsche mark-USD exchange rates related to the forecasted receipt of DM 3 million. Since the forward is hedging foreign currency exposure on a forecasted transaction, gains and losses on the forward are recognized in other comprehensive income. As payments on the license are made, the receivable becomes an asset, not a forecasted transaction, and is no longer eligible for either cash flow hedge accounting or for fair value hedge accounting of the foreign exchange risk due to changes in the receivable's fair value due to exchange rate changes. Therefore, as each payment on the license is made, a portion of the derivative must be dedesignated and the related derivative gain or loss in accumulated other comprehensive income is reclassified into earnings.

Though there is an agreement to receive nonfunctional currency in the future, it may not be precisely for DM 3 million, since Zorba may not sell that many systems, or may sell more. Nevertheless, there is an agreement under which DenCo will receive nonfunctional currency in the future with respect to the sale of property (the right under the license) held for sale in the ordinary course of DenCo's business. Thus, this transaction appears to satisfy the requirements for being classified as a hedged executory contract under Treasury Regulation 1.988-5(b)(2).

The Regulation also provides that a contract to buy or sell stock, such as the stock of an affiliate, is an executory contract. On the accrual date, the contract ceases to be an executory contract and is treated as an account payable or receivable. An executory contract does not include a Section 988 transaction.<sup>159</sup>

---

<sup>158</sup> Example adapted from Example 10: CASH FLOW HEDGE OF THE FOREIGN CURRENCY EXPOSURE IN A ROYALTY ARRANGEMENT, SFAS 133 §§ 165-72.

<sup>159</sup> Treas. Reg. § 1.988-5(b)(ii)(B) (2000). Thus, a forward contract to purchase nonfunctional currency is not an executory contract.

A hedged executory contract is one that is subject to a hedge, which is a deposit of nonfunctional currency in a hedging account, a future or forward, or combination thereof, which reduces the risk of exchange rate fluctuations by reference to the taxpayer's functional currency with respect to nonfunctional currency payments made or received under an executory contract.<sup>160</sup> An option contract can also be a hedge but only if the option's expiration date is on or before the accrual date.<sup>161</sup> Hedges can be a series of instruments if the hedge that succeeds a hedge that has been terminated is entered into no later than the business day following that termination.<sup>162</sup> "Historical rate rollovers" can be hedges under Treasury Regulation 1.988-5(b)(2)(iii)(C). An historical rate rollover is an extension of the maturity date of a forward contract where the new forward rate is adjusted on the rollover date. The adjustment reflects gain or loss as of the rollover date plus the time value of the gain or loss through the new maturity date.<sup>163</sup>

A hedging account is an account with a financial institution used exclusively for deposits of nonfunctional currency used to hedge executory contracts.<sup>164</sup> Interest income on a deposit of nonfunctional currency in a hedging account may be taken into account for purposes of determining the amount of a hedge if the interest is accrued on or before the accrual date.<sup>165</sup> Thus, to use the simplest regulatory example, if a taxpayer having the U.S. dollar as its functional currency enters into an executory contract for the purchase of a machine in one year at £ 100, and deposits \$90.91 in a an account that bears interest at ten percent, the interest that accrues prior to the accrual date is included income and is part of the hedge.<sup>166</sup>

---

<sup>160</sup> Treas. Reg. § 1.988-5(b)(2)(iii)(A) (2000). Presumably, a swap can be a combination or series of forwards. But this is doubted by some commentators. See, e.g., Bruce H. Weinrib et al., *Final and Proposed Regulations Expand Available Foreign Currency Hedging Opportunities*, 77 J. TAX'N 23 n.110 (1992).

<sup>161</sup> *Id.* The premium paid for an option that lapses is integrated with the executory contract.

<sup>162</sup> Treas. Reg. § 1.988-5(b)(2)(iii)(B) (2000). For an example of how a series of forward contracts can function as a hedge, see Treasury Regulation § 1.988-5(b)(4)(vi), Example (6)(iii).

<sup>163</sup> Special rules for the treatment of interest income or expense on such a transaction are provided in Treasury Regulation § 1.988-5(b)(2)(iii)(C)(3). For an example, see Treasury Regulation § 1.988-5(b)(4)(vi), Example (6)(iv).

<sup>164</sup> Treas. Reg. § 1.988-5(b)(2)(D) (2000).

<sup>165</sup> The interest is included in income under 26 U.S.C. § 61 (1994).

<sup>166</sup> See also Treas. Reg. § 1.988-5(b)(4)(vi), Example (6)(v) (2000). The accrual date, under Treasury Regulation § 1.988-5(b)(iv), is the date when the item of income or expense that relates to an executory contract is required to be ac-

When a taxpayer enters into a hedged executory contract, payments or receipts under the hedge are treated as paid or received by the taxpayer under the executory contract, or any subsequent account payable or receivable. The taxpayer recognizes no exchange gain or loss on the hedge.

*Example Seventeen.* On January 1, 2000, Karma Corp. enters into a contract with JPF, a Swiss heavy equipment manufacturer, to deliver a press on June 1, 2001. Karma will pay 500,000 Swiss francs (SF) on delivery. On January 1, 2000, Karma also enters into a forward contract to purchase 500,000 SF for \$250,000 on June 1, 2001, and identifies the executory contract and the hedge as together a hedged executory contract before the close of business on January 1, 2000. Under Karma's method of accounting, June 1, 2001, is the accrual date. Karma is deemed to have paid \$250,000 for the press (which is also Karma's basis) and there is no exchange gain or loss on the foreign currency forward contract.<sup>167</sup> Under other circumstances, Section 1256 might apply to the forward contract, but if the requirements for integration under Section 988(d) are satisfied, Section 1256 does not apply.

A hedge may cover only a portion of the executory contract. The amount realized or the basis of property sold or purchase under the executory contract that is attributable to that portion of the executory contract that is not hedged is translated into functional currency on the accrual date.<sup>168</sup> Sections 263(g), 1092, and 1256 do not apply separately to the executory contract or the hedge separately, but "may apply to the hedged executory contract if such transaction is part of a straddle."<sup>169</sup>

### *M. Hedges of Nonfunctional Currency Dividends*

Under regulations originally proposed in 1992 and still in that form, declared but unpaid dividends or accrued rent or royalty payments, if denominated in a nonfunctional currency as to the recipient, may be the subject of a Section 988(d) hedge. The hedge must be a deposit of nonfunctional currency in a hedging account or a future, forward, option or "similar financial instrument" payable or determined by reference to a nonfunctional currency, or a combination of these, that reduces the risk of exchange rate fluctuations. For an option to be a hedge, it must expire

---

crued under the taxpayer's method of accounting. For an example where interest earned after the accrual date is not considered part of the hedge, see Treasury Regulation § 1.988-5(b)(vi), Example (4).

<sup>167</sup> Treas. Reg. § 1.988-5(b)(4)(vi), Example (1) (2000).

<sup>168</sup> Treas. Reg. §§ 1.988-5(b)(4)(ii), -5(b)(4)(vi), Example (5) (2000).

<sup>169</sup> Treas. Reg. § 1.988-5(b)(4)(v) (2000).

on or before the accrual date and must be exercised on or before that date. The premium paid for an option that lapses is integrated with the dividend or royalty (the "qualified payment"). As with hedged executory contracts, a series of hedges, or an historical rate rollover, can function as a hedge.<sup>170</sup>

The accrual date for calculations on such hedges is the date the dividend, rent, or royalty must be accrued under the taxpayer's method of accounting. A taxpayer can use any reasonable convention consistently applied to translate an accrued payment into the taxpayer's functional currency.

*Example Eighteen.* Qinko Corp. is a U.S. corporation that has a business unit, Qinko, with its principal place of business in Canada. Qinko's functional currency is the U.S. dollar. On January 1, 2000, Qinko enters into a three-year lease to rent a building in Toronto for annual payments of \$6 million Canadian on March 31 of each year. On February 1, 2000, Qinko enters into a forward contract to buy C\$6 million for U.S.\$5.2 million. Qinko enters into similar contracts on February 1, 2001, and February 1, 2002, each time to purchase the C\$6 million for the rent on the building. If the requirements for integration under Proposed Treasury Regulation 1.988-5(d)(2)(i) are satisfied, Qinko may integrate the forward contracts with the rental payments.<sup>171</sup>

#### *N. Mark-to-Market Treatment of Section 988 Transactions*

Taxpayers that are not acting in their capacities as dealers or traders in nonfunctional currencies or nonfunctional currency denominated instruments may elect mark-to-market treatment of all its Section 988 transactions. Under Proposed Treasury Regulation 1.988-5(f)(2), a taxpayer making this election realizes for the tax year exchange gain or loss on Section 988 transactions that results from changes in exchange rates

---

<sup>170</sup> Treas. Reg. §§ 1.988-5(d)(2)(iii)(B) and (C) (2000). The treatment of interest also parallels that for hedged executory contracts. Treas. Reg. § 1.988-5(d)(2)(iii)(D) (2000). Also, the application of 26 U.S.C. §§ 263(g), 1092, and 1256 operates on the same principle as to a hedged nonfunctional currency contract. Treas. Reg. § 1.988-5(d)(3)(vi) (2000).

<sup>171</sup> Prop. Treas. Reg. § 1.988-5(d)(3)(vii), Example (1), 57 Fed. Reg. 9217 (1992). See Example 3: FAIR VALUE HEDGE—USING A FORWARD CONTRACT TO PURCHASE FOREIGN CURRENCY TO HEDGE A FIRM COMMITMENT DENOMINATED IN A DIFFERENT FOREIGN CURRENCY, SFAS 133 § 121, for an illustration of how the ineffectiveness resulting from hedging one currency with another is recognized immediately in earnings.

between the date a financial accounting period begins and the date a financial accounting period closes, but no less frequently than quarterly. This treatment, according to the proposed regulation, must be consistent with the taxpayer's method for financial reporting purposes, which method must conform to U.S. generally accepted accounting principles.<sup>172</sup> If a taxpayer makes this mark-to-market election, each person related to the taxpayer under Section 267(b) or 707(b) is deemed to make the election, unless the person is a dealer or trader that could not make the election in any case.

A taxpayer that makes this election for mark-to-market treatment of Section 988 transactions must account for Section 988 hedging transactions under Treasury Regulations 1.988-5(a) through -5(f), i.e., as integrated transactions that are not marked to market. If the taxpayer fails to satisfy identification or other requirements for hedge accounting, however, the transactions involved must be marked to market, even if the taxpayer is using hedge accounting for financial reporting purposes.

#### *O. Hedging Transactions of Controlled Foreign Corporations*

A controlled foreign corporation (CFC) is a foreign corporation as to which more than 50 percent of (1) the total combined voting power of all classes of its stock entitled, or (2) the total value of all its stock, is owned by U.S. shareholders.<sup>173</sup> A U.S. shareholder of a CFC must include in gross income its pro rata share of the CFC's subpart F income. Subpart F income includes foreign base company income, which includes, under Section 954(a), foreign personal holding company income. Under Section 954(c)(1)(D), the excess of foreign currency gains over foreign currency losses is included in foreign personal holding company income unless "directly related to the business needs of the controlled foreign corporation." Income from a notional principal contract entered into to hedge any item that would otherwise give risk to foreign personal holding company income is taken into account along with the hedged item.<sup>174</sup>

Under Treasury Regulation 1.954-2(g)(2)(ii)(B)(2), foreign currency gain or loss is directly related to the business needs of a CFC if it arises from a bona fide hedging transaction. Regulation 1.954-2(a)(4)(ii)

---

<sup>172</sup> "Realizing the gain or loss resulting from changes in exchange rates between the date a financial accounting period begins the date a financial accounting period closes" is, under Proposed Treasury Regulation § 1.988-5(f)(2), "referred to as marking to market."

<sup>173</sup> 26 U.S.C. § 957(a) (1994).

<sup>174</sup> 26 U.S.C. § 954(c)(1)(F) (1994).

defines a bona fide hedging transaction as one that meets the requirement of Treasury Regulations 1.1221-2(a) through (c). The risk being hedged, however, in addition to ordinary property or a Section 988 transaction, can include Section 1231 property.<sup>175</sup> A transaction that hedges liabilities, inventory or other assets of a related person (defined in Section 954(d)(3), or that is entered into to assume or reduce risks (now—manage risks?) of a related person, is not a bona fide hedging transaction. Transactions entered into by dealers that are CFCs and that are regular dealers in financial instruments, even if those financial instruments serve as hedges, are treated as directly related to the business needs of the CFC.<sup>176</sup>

#### *F. Anticipated Transactions*

The FASB's efforts in creating SFAS 133 involved detailed consideration of the implications of allowing hedging treatment of forecasted transactions. The resulting regime is curious, given that the Board argues in SFAS 133 ¶ 328<sup>177</sup> that hedging of forecasted transactions is not "conceptually supportable."

Gains and losses on derivative instruments designated as hedges of forecasted transactions can be distinguished from gains and losses on other derivatives only on the basis of management intent. That makes hedge accounting for forecasted transactions problematic from a practical, as well as a conceptual, perspective. Furthermore, it generally is more difficult to assess the effectiveness of a hedge of a forecasted transaction than of a hedge of an existing

---

<sup>175</sup> The aggregate risk requirement of Treasury Regulation § 1.1221-2(c)(7) is appropriately expanded to include these property categories. Treas. Reg. § 1.954-2(g)(2)(ii)(B)(2) (2000). Several commentators appropriately note: "As a practical matter, because of the specific requirements of these provisions (including the identification requirements), taxpayers should consider implementing policies and procedures to ensure that CFC transactions qualify under these rules [to avoid foreign personal holding company income]." WEINRIB ET AL., *supra* note 160, at 36.

<sup>176</sup> Treas. Reg. § 1.954-2(g)(2)(ii)(C) (2000). The only way a hedge center can qualify hedges of activities of related corporations as bona fide hedging transactions is by being a regular dealer. *See* Treas. Reg. § 1.954-2(g)(ii)(D), Example (i) (2000).

<sup>177</sup> Admittedly in an appendix providing background information to the Statement.

asset or liability, because a forecasted transaction reflects expectations and intent, not measurable present rights or obligations.<sup>178</sup>

The Board decided to allow some hedges of forecasted transactions “because of the current widespread use of and demand for special accounting for forecasted transactions.”<sup>179</sup>

For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction, the effective portion of the derivative’s gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings.<sup>180</sup> The ineffective portion of the gain or loss is immediately reported in earnings. Similarly, the accounting for a cash flow hedge applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction (a foreign currency cash flow hedge).

Under SFAS 133 ¶ 29, a forecasted transaction can be designated as a hedged transaction in a cash flow hedge only if all the following apply:

1. The forecasted transaction is specifically identified as a single transaction or a group of individual transactions. If the hedged transaction is a group of individual transactions, those individual transactions must share the same risk exposure for which they are designated as being hedged. Thus, a forecasted purchase and a forecasted sale cannot both be included in the same group of individual transactions that constitute the hedged transaction.
2. The occurrence of the forecasted transaction is probable.
3. The forecasted transaction is a transaction with a party external to the reporting entity (except as permitted with certain

---

<sup>178</sup> SFAS 133 § 327.

<sup>179</sup> SFAS 133 § 328.

<sup>180</sup> SFAS 133 § 459: “The Exposure Draft would have required that an entity be able to predict the date on which a forecasted transaction will occur for it to qualify for cash flow hedge accounting. The Exposure Draft also would have required the gain or loss on a derivative that hedges a forecasted transaction to be reclassified into earnings on the date that the forecasted transaction was expected to occur. This Statement instead requires the gain or loss on a hedge of a forecasted transaction to be reclassified into earnings in the same period(s) that the hedged transaction affects earnings. That change makes it less important for an entity to be able to predict the exact date on which a hedged forecasted transaction will occur.”

intercompany foreign-currency denominated transactions under SFAS ¶ SF 40) and presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

4. The forecasted transaction does not involve acquiring an asset or incurring a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.
5. If the variable cash flows of the forecasted transaction relate to a debt security classified as held-to-maturity under Statement 115, the risk being hedged is the risk of changes in its cash flows attributable to credit risk, foreign exchange risk, or both.<sup>181</sup>
6. The forecasted transaction generally does not involve a business combination.

The Board had considered adding a requirement that cash flow hedge accounting only be available for derivatives instruments with a contractual maturity or repricing date that was on or about the date of the hedged forecasted transaction. This requirement was not added because of objections from the accounting community.<sup>182</sup> The Statement also places no limitations on an entity's ability to prospectively designate, dedesignate, and redesignate a qualifying hedge of the same forecasted transaction.<sup>183</sup>

If the hedged transaction is the forecasted purchase or sale of a nonfinancial asset, the designated risk being hedged must be either (1) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or (2) the risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset (reflecting its actual location if a physical asset), not the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location or of a major ingredient. SFAS 133 ¶ 29(g) indicates, for instance, that hedging the exposure to changes in the cash flows relating to the purchase of its

---

<sup>181</sup> SFAS 133 § 29(e), as amended by SFAS 138 § 4(e)(1).

<sup>182</sup> The objections were to the effect that such a requirement would have precluded rollover strategies — using a series of short-term futures, options, or both, in consecutive months — and hedges of a portion of the term of a forecasted transaction from qualifying for hedge accounting. SFAS 133 § 467.

<sup>183</sup> SFAS 133 § 358. “The result of those provisions is that this Statement permits an entity to exclude derivative gains or losses from earnings and recognize them in other comprehensive income even if its objective is to achieve a desired level of risk based on its view of the market rather than to reduce risk.” *Id.*

bronze bar inventory, an entity may not designate the risk of changes in the cash flows relating to purchasing the copper component in bronze as the risk being hedged.<sup>184</sup>

If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged must be one of the following:

1. Risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price,
2. Risk of changes in its cash flows due to interest rate risk,<sup>185</sup>
3. Risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates, or
4. Risk of changes in its cash flows due to default, changes in the obligor's creditworthiness, and changes in the spread over the benchmark interest rate in the hedged item's credit sector at inception of the hedge.<sup>186</sup>

Two or more of the above risks may be designated simultaneously as being hedged. An entity may not, however, designate prepayment risk as the risk being hedged.<sup>187</sup>

Under SFAS 133 ¶ 31, amounts put in accumulated other comprehensive income on a cash flow hedge of a forecasted transaction are reclassified into earnings in the same period or periods in which the hedged forecasted transaction affects earnings—generally when a forecasted sale actually occurs. If the hedged transaction results in the acquisition of an asset or the incurring of a liability, the gains and losses in accumulated other comprehensive income are reclassified to earnings in the same period or periods in which the asset acquired or liability incurred affects earnings (such as in the periods the depreciation expense, interest expense, or cost of sales is recognized).

A cash flow hedge is discontinued if it becomes probable that the original forecasted transaction will not occur, and any net gain or loss in accumulated other comprehensive income will, in most cases, immedi-

<sup>184</sup> However, this does not necessarily mean that a copper future could not hedge bronze inventory, if an entity could establish that the hedge could be expected to be highly effective. See SFAS 133 § 94-97.

<sup>185</sup> SFAS 138 § 4(c) changed the original wording of SFAS 133 ¶ 29(h)(2) to reflect the benchmark interest rate concept introduced by SFAS 138. Previously, SFAS 133 had referred to market interest rates as the risk being hedged.

<sup>186</sup> SFAS 133 § 29(h)(4), as amended by SFAS 138 § 4(c)(7).

<sup>187</sup> SFAS 133 § 29(h).

ately be reclassified into earnings.<sup>188</sup> SFAS 138 added an exception for “rare cases” where “extenuating circumstances” related to the nature of the forecasted transaction but outside the control or influence of the reporting entity “may cause the forecasted transaction to be probable of occurring” at a later time. Under such rare circumstances, reclassification could be postponed significantly.<sup>189</sup>

Under Treasury Regulation 1.1221-2(b), a hedging transaction can be one entered into primarily to reduce risk of price changes or currency fluctuations as to ordinary property that will be held by the taxpayer. As noted above, this regulatory requirement will be changed to refer to managing risk, not necessarily reducing it. A hedging transaction can also be entered into primarily to reduce (manage) risk of interest rate or price changes or currency fluctuations as to borrowings to be made, or ordinary obligations to be incurred, by the taxpayer. The risk reduction (management) requirements apply to such future assets, borrowings, or obligations. Under Treasury Regulation 1.446-4(e)(3) and (4), anticipated purchases or sales of inventory may be hedged, as may debt issues the taxpayer expects to issue in the future. If a taxpayer enters into a hedging transaction to reduce risk on an anticipated asset acquisition, debt issuance, or obligation, “any income, deduction, gain, or loss from the hedging transaction is taken into account when realized.”<sup>190</sup>

Unfortunately, the author is not aware of any interpretations in any IRS releases that adds any information to its sparse regulatory structure. The financial accounting limitations on hedging anticipated transactions could probably be useful if the area is found to be breeding any tax abuse patterns, but until then, additional tax regulation is probably unnecessary.

---

<sup>188</sup> SFAS 133 § 33. Initially, the Board had proposed that if cash flow hedge accounting were discontinued, the derivative gain or loss accumulated in other comprehensive income to the date of discontinuance would only be recognized in earnings on the originally projected date of the hedged forecasted transaction. SFAS 133 § 492. The Board was concerned that requiring a gain or loss in accumulated other comprehensive income to be reported in earnings when a forecasted transaction is no longer probable but still is reasonably possible “would provide an entity with the opportunity to manage earnings by changing its estimate of probability.” *Id.* SFAS 138 § 4(q) added a two-month grace period to the end of the originally specified time period where the occurrence of the forecasted transaction could occur without reclassifying OCI into earnings. SFAS 138 § 4(q).

<sup>189</sup> SFAS 133 § 33, *as amended by* SFAS 138 § 4(q).

<sup>190</sup> Treas. Reg. § 1.446-4(e)(8)(i) (2000).

## VIII. STRADDLES

The distinction between hedges and straddles has at times been considered by the IRS and the Treasury. In issuing the final Section 1221 hedging regulations, the Preamble notes that "gap" hedges were not allowed under the regulations:

Insurance companies, for example, sometimes hedge the "gap" between their liabilities and the assets that fund them. Under the proposed regulations, a hedge of those assets does not qualify as a hedging transaction if the assets are capital . . . . The IRS and Treasury . . . are concerned that, where this type of hedge is more closely associated with the assets than the liabilities, there is a significant possibility of mismatch if the hedges are given ordinary treatment and the assets can be sold for capital gains. . . . The IRS and Treasury understand that the most significant consequence of the failure of gap hedges to qualify as hedging transactions may be that they are then subject to the straddle rules of section 1092.

As noted above, a hedge for financial accounting purposes may not be a hedge for tax purposes, but an economic hedge of the fair value of a capital asset can obviously be a straddle. A tax system that adopted financial hedge accounting principles would probably allow hedges of capital assets.<sup>191</sup>

*Example Nineteen.* ZippoCo has an investment portfolio of corporate bonds that pay a fixed rate. The portfolio has primarily been financed with floating rate debt, and ZippoCo wants to lock in the spread between its interest income and its borrowing costs. Therefore, ZippoCo enters into an interest rate swap contract under which it pays a fixed rate and receives a floating rate. Under SFAS 133, ZippoCo could treat the interest rate swap as a fair value hedge of the corporate bonds. Alternatively, it could be viewed as a cash flow hedge of the floating rate debt.

From a tax perspective, the interest rate swap, if it satisfied the requirements for hedge accounting, could be treated as hedging the floating rate debt if reduces risk (certainly, it manages risk) of interest rate changes on borrowings incurred by the taxpayer.<sup>192</sup> There may even be integration under Treasury Regulation 1.1275-6 of the swap and the

---

<sup>191</sup> To some extent, 26 U.S.C. § 1092 gives taxpayers some control over straddle situations through identification and mixed straddle account provisions. See 26 U.S.C. § 1092(a)(2) (1994); § 1092(b)(2)(A) (1994).

<sup>192</sup> Treas. Reg. § 1.1221-2(b)(2) (2000).

floating rate debt if the combined cash flows “are substantially equivalent to” the cash flows on a fixed rate debt instrument.

If the fixed rate bonds are ordinary income property, the swap could be treated as a hedge of the price changes on that property.<sup>193</sup> If the property is actively traded personal property, this “economic” hedge could be a straddle, though not if the hedging rules were already being applied.<sup>194</sup> It is conceivable that the taxpayer would identify such a straddle under Section 1092(a)(2).

The Clinton administration’s 2001 Budget proposed to introduce some mark-to-market methodologies in straddle calculations, such as where a taxpayer delivers property to settle an option or forward that is a leg of a straddle.<sup>195</sup>

### IX. CONVERSION TRANSACTIONS

Section 1258 operates to integrate two transactions involving the same property for the purpose of converting an otherwise capital gain into ordinary income.<sup>196</sup> The transaction can be a straddle. Thus, a purchase of stock and the simultaneous entering into of a forward to sell the stock in six months at a higher price would, under general capital transaction rules, produce capital gain. Because all of the expected return on the transaction is attributable to the time value of the net investment, this is a conversion transaction.<sup>197</sup>

Under accounting rules, the forward is marked to market under SFAS 133. The securities would be marked to market if the forward was classified as a fair value hedge of the securities, but not necessarily otherwise. If classified as trading securities, unrealized holding gains and losses

---

<sup>193</sup> This example is adapted from the discussion in Gary A. Herrmann & Steven C. Malvey, *New Rules for Business Hedges Resolve Many Uncertainties of Arkansas Best*, 80 J. TAX’N, 132, n.3 (Mar. 1994). The authors assume that the interest rate swap could be viewed as a hedge of the price risk of the bonds.

<sup>194</sup> 26 U.S.C. § 1092(e) (1994).

<sup>195</sup> See Treasury Reports, General Explanation of the Administration’s Fiscal Year 2001 Revenue Proposals § 718 (Feb. 21, 2001) <<http://www.nysba.org/sectoins/tax/menu/itresmenu.htm>>. For a discussion of the proposals, and suggested refinements, see letter of Samuel J. Dimon on behalf of New York State Bar Association Tax Section to Jonathan Talisman, Acting Assistant Secretary (Tax Policy) (Mar. 17, 2000) (2000 TNT 57-25).

<sup>196</sup> Professor Weisbach classifies the straddle and conversion regimes as “partial integration” approaches, Weisbach, *supra* note 1, at 526.

<sup>197</sup> 26 U.S.C. § 1258(c)(2)(B) (1994); Treas. Reg. § 1.1258-1(d), Example (1) (2000).

are included in earnings.<sup>198</sup> If the securities are classified as available-for-sale securities, unrealized holding gains and losses are excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized.<sup>199</sup>

#### X. CONSTRUCTIVE SALES

A constructive sale, by combining an appreciated financial position with a transaction that takes advantage of that position, is, as with a straddle, a sort of enforced hedging arrangement. An appreciated financial position is a position in stock, a debt instrument, or a partnership interest, which would produce gain if sold, assigned, or terminated. An appreciated financial position does not include:

1. A position in straight debt that entitles the holder to a specified principal amount, fixed or variable interest (or a portion of interest payments on mortgages under Section 860G(a)(1)(B)(i), and that is not convertible into stock of the issuer or a related corporation.
2. Any hedge of a position described in the previous point (1).
3. Any position that is marked to market.

A position is an interest, which can include a future, forward, option, or short sale.<sup>200</sup> A constructive sale of an appreciated financial position occurs when the taxpayer or a related person:

1. Enters into a short sale of the same or substantially identical property.
2. Enters into an offsetting notional principal contract on the same or substantially identical property. This generally means an equity swap such that the taxpayer pays the investment yield, including appreciation, for a period, while receiving a right to be reimbursed for the decline in value of the property.<sup>201</sup>
3. Enters into a futures or forward contract to deliver the same or substantially identical property.
4. If the appreciated financial position is itself a short sale, acquires the same or substantially identical property.

---

<sup>198</sup> Investments bought and held principally for the purpose of selling them in the near term are classified as trading securities. SFAS 115 §§ 13, 80.

<sup>199</sup> SFAS 115 §§ 13, 90-95. Debt securities that an enterprise intends to hold to maturity are classified as held-to-maturity securities, which are measured at amortized cost in the statement of financial position. *Id.* at 7.

<sup>200</sup> A short sale is generally not a derivative because it fails the SFAS 133 requirement that there be little or no initial net investment. SFAS 133 § 59(d).

<sup>201</sup> 26 U.S.C. § 1259(d)(2) (1994).

A constructive sale does not include a contract for sale of stock, debt, or partnership interest if the interest is not a marketable security if the contract settles within a year after the date the contract is entered into. The Treasury has the authority to issue regulations to flesh out the definition, but has not proposed any as of this writing. The impact of this section generally can be avoided if the taxpayer accepts exposure on the appreciated financial position for a 60-day period each tax year.<sup>202</sup>

Under SFAS 133, the transactions would be treated separately, but where there was a hedge, the hedged instrument would be marked to market along with the offsetting derivative. Consistency for this treatment would require that all financial instruments be marked to market, so that short sales and other transactions deemed to be constructive sales would be treated the same as forwards and notional principal contracts that achieve "constructive sale" objectives.

### XI. DEALERS IN SECURITIES

Under Section 475(a), any security that is inventory in the hands of a dealer must be included in inventory at fair market value. A dealer in securities is a taxpayer that regularly purchases or sells securities to customers in the ordinary course of a trade or business. A dealer can also be someone who enters into, assumes, offsets, assigns, or otherwise terminates positions in securities for customers.<sup>203</sup> A security is:

1. A share of stock
2. A partnership or beneficial ownership interest
3. A note, bond, debenture, or other evidence of indebtedness. This does not include "nonfinancial customer paper," which includes, for instance, a note for the purchase of a car that is issued to the car dealer and remains in the hands of the car dealer.<sup>204</sup>
4. An interest rate, currency, or equity notional principal contract
5. A derivative financial instrument, including an option or forward, or a short position, with an underlying contract that is one of the instruments listed in one to four; or any currency and any similar financial instrument in the currency. This provi-

---

<sup>202</sup> 26 U.S.C. § 1259(c)(3) (1994).

<sup>203</sup> See Treas. Reg. § 1.475(c)-1(a)(2)(ii) Example (1) (2000) (a party regularly offering to enter into interest rate swaps under which it pays fixed and receives floating and vice versa is a dealer, and the counterparties are its customers).

<sup>204</sup> 26 U.S.C. § 475(c)(4) (1994). Treas. Reg. § 1.475(c)-1(b)(2) (2000). Synthetic debt, as defined in Treasury Regulation § 1.1275(b)(4), is a security. Treas. Reg. § 1.475(c)-2(b) (2000).

sion does not include Section 1256 contracts, which are marked to market under that section.

6. A hedge of a transaction listed in one to five that is not one of such transactions, that has been identified in the dealer's records before the close of the day on which it was acquired or entered into. A hedge, for this purpose, is any position reducing the dealer's risk of interest rate, price changes, or currency fluctuations, and includes "any position which is reasonably expect to become a hedge within 60 days after the acquisition of the position."

A security that is not inventory to the dealer, unless generally held for investment or not held for sale, is also marked to market at the close of any tax year. If a dealer wishes to avoid mark-to-market accounting as to an investment security, the instrument must be identified before the close of the day on which it was acquired or entered into as being exempt from the mark-to-market rules.<sup>205</sup>

If a taxpayer misidentifies a security as being exempt from mark-to-market accounting, but the security should not be exempt, the mark-to-market rules apply to the instrument in any case. In addition, any loss that might result in marking the instrument to market is recognized only to the extent of gain previously recognized under Section 475.<sup>206</sup> This penalization of a misidentification—precluding net losses prior to disposition—also applies to hedges that the taxpayer fails to make of a hedge under Section 475(c)(2)(F)(i) and (ii). Thus, under the tax hedging rules, a hedge can be designated by the IRS—which must determine that the taxpayer should have identified a hedge because there was one—with a result similar to the straddle rules. That is, the resulting imposed hedge becomes one-sided with respect to losses, though unlike a straddle, losses can be recognized to the extent of gains recognized prior to disposition. Even if a security has properly avoided mark-to-market accounting, the mark-to-market rules apply if the reason for its exemption from the rules ceases to apply—e.g., if a security held for investment is placed in an inventory account.<sup>207</sup>

Under Treasury Regulation 1.475(b)-1(c), dealers in interest rate, currency, or equity notional principal contracts cannot, absent a contrary ruling from the IRS, be considered as exempt from the mark-to-market requirements under Section 475(b)(1). This also applies to dealers in derivatives with underlyings listed in one through four of the list above, as well

---

<sup>205</sup> The identification must indicate that the security is exempt because it is (1) held for investment or not for sale, or (2) a hedge.

<sup>206</sup> 26 U.S.C. § 475(d)(2) (1994).

<sup>207</sup> 26 U.S.C. § 475(b)(3) (1994).

as dealers in any currency, including options, forwards, short positions, and any similar financial instrument in such a security or currency. Thus, dealers in derivatives have little leeway in avoiding the mark-to-market requirements for any derivatives they hold.

Because the dealer is marking its instruments to market, there is no reason to capitalize interest under Section 263(g) or inventory costs under Section 263A. Instruments covered by Section 1256(a) are already marked to market under that section, and are thus not accounted for under Section 475.

Gain or loss for dealer transactions that are marked to market is generally ordinary income or loss. Under Section 1236(a), gain by a dealer in securities from the sale or exchange of any security is “in no event” gain from the sale or exchange of a capital asset unless the dealer has identified it as held for investment on the day of acquisition and, after such identification, the security was never held by the dealer primarily for sale to customers. In other words, if the dealer ever lists the security as inventory, disposition will produce ordinary income. The definition of security for purposes of Section 1236 is narrower than that of Section 475, and is limited to “any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing.” This definition does not include notional principal contracts, derivatives other than call options on securities, or hedging instruments.

Section 475 has its own character provision, which provides that for securities—using the broader Section 475 definition now—that are not inventory but which are marked to market under Section 475(a)(2), gain or loss produces ordinary income.<sup>208</sup> Dealers in commodities can elect mark-to-market treatment under Section 475(e), as can traders in commodities or securities under Section 475(f).<sup>209</sup>

---

<sup>208</sup> 26 U.S.C. § 475(d)(3)(B) provides exceptions for securities used in hedges, or held by a dealer other than in its activities as a dealer, or is improperly identified. 26 U.S.C. § 475(d)(3)(B) (1994).

<sup>209</sup> Those electing mark-to-market treatment can have difficulty avoiding marking investments to market. Prop. Treas. Reg. § 1.475(e)-1(c), 64 Fed. Reg. 4374 (1999); Prop. Treas. Reg. § 1.475(f)-2(a)(3), (4), 64 Fed. Reg. 4374 (1999). If a trader in commodities makes an election for mark-to-market treatment under 26 U.S.C. § 475(f)(2), any Section 1256 contracts that are commodities are not subject to the capital character rules of Section 1256, but to the rules of Section 475(f).

## XII. CONSOLIDATED GROUPS

Because a hedged item must embody an exposure to changes in fair value or variations in cash flow for the risk being hedged, that could affect reported earnings, intercompany transactions between entities included in consolidated financial statements are specifically excluded from hedge accounting under SFAS 133. Thus, depreciation expense, cost of sales, and similar internal accounting allocations do not qualify as hedgeable forecasted transactions. Forecasted transactions between members of a consolidated entity, except for intercompany transactions denominated in a foreign currency, are not hedgeable transactions except for purposes of separate stand-alone subsidiary financial statements.

The single exception to this limitation on intercompany transactions concerns foreign-currency-denominated forecasted intercompany transactions. Thus, under SFAS 133 ¶ 36, a foreign currency derivative instrument that has been entered into with another member of a consolidated group can be a hedging instrument (in a fair value or cash flow hedge of a recognized foreign-currency-denominated asset or liability or in a net investment hedge) in the consolidated financial statements if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.<sup>210</sup>

The tax law generally applies a single-entity approach to a consolidated group. Thus, the risk of one member of a consolidated group is treated as the risk of the other members, "as if all the members of the group were divisions of a single corporation."<sup>211</sup> A consolidated group can, however, make a separate-entity election. If this election is made, if the parties are related, the party providing the hedge must generally use a mark-to-market method for the hedge.<sup>212</sup> In a Treasury Regulation 1.988-

---

<sup>210</sup> SFAS 133 § 36, as amended by SFAS 138. SFAS 138 added new paragraph 40B to SFAS 133 to allow a treasury center to offset net exposure to certain foreign currency transactions of a group filing a consolidated financial statement.

<sup>211</sup> Treas. Reg. § 1.1221-2(d)(1) (2000). For planning regarding centralized hedging functions, see Michael Leonowitz et al., *Global Risk Management: Hedge Center Tax Considerations*, J. OF TAX. OF FIN. PRODS. Spring 2000, at 24.

<sup>212</sup> Treas. Reg. §§ 1.1275-6(c)(1)(ii), 1.1221-2(d)(2)(ii)(B) (requiring also, in Treasury Regulation § 1.1221-2(d)(2)(iii)(B), that gain or loss of the "marking member" be ordinary); see Treas. Reg. § 1.1221-2(d)(4), Examples (1) and (2) (2000). Where an intercompany transaction is not a hedging transaction because, for instance, of failure to satisfy the mark-to-market requirement on the hedge, the intercompany hedging transaction is taken into account under Treasury Regulation § 1.1502-13. Changes to the regulations regarding straddles and hedging transactions were proposed by Treasury in January 2001 (REG-107047-

5(a) hedge, none of the parties to the hedge can be related, even if both corporations are members of the same U.S. consolidated group.<sup>213</sup>

### XIII. SHOULD FINANCIAL ACCOUNTING PRACTICE INFLUENCE TAX LAW?

Financial accounting has not generally been seen as having any broad authority to govern the tax law.<sup>214</sup> With SFAS 133, resulting in the replacement of historical cost with fair value accounting for derivatives (and, with other initiatives, soon perhaps for other financial instruments), the accounting system comes much closer to satisfying the clear reflection of income standard required under Treasury Regulation 1.446-4(b).<sup>215</sup> The question posed here is not whether financial accounting practices *should* control the tax law, but whether a system in which one of the two approaches adopted as much of the other as possible would be workable. A partial bifurcation system, such as that advanced in SFAS 133, could apply in the tax law only with, in the words of David S. Miller, “the development of broad principles of taxation to apply to all financial instruments, regardless of their characterization.”<sup>216</sup> With that premise accepted—with a general bifurcation approach used to determine the units for valuation, it is suggested that this system would be both workable and efficient. This is not to say it would be politically popular, or even acceptable, though the latter difficulty could be partially resolved were implementation connected with a rate cut (even conceivably with something approaching a flat tax).

---

00, 66 Fed. Reg. 4738 (January 18, 2001) and REG-105801-00, 66 Fed. Reg. 4746 (January 18, 2001)) but were released after this article was completed and are not discussed here.

<sup>213</sup> Treas. Reg. § 1.988-5(a)(5)(iii) (2000).

<sup>214</sup> See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561, 577 (1978) (“[T]he characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same.”) See also *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 543 (1979) (“[A]ny presumptive equivalency between tax and financial accounting would be unacceptable.”)

<sup>215</sup> See David S. Miller, *Reconciling Policies and Practice in the Taxation of Financial Instruments*, 77 TAXES 236, 244 n.122 1999.

<sup>216</sup> *Id.* Miller refers to this as the “super-cubbyhole consistency approach.” *Id.* at 244 n.125. “[A]n across-the-board mark-to-market regime would effect consistency and clear economic reflection of income principles, but at the cost of tax liquidity and difficult administration (i.e., valuation) issues.” *Id.* Nevertheless, the increasing sophistication of valuation software (including value-at-risk, “VAR,” software) suggests that valuation issues may be overplayed in tax analysis of these questions.

The basic argument for bifurcation of hybrid instruments has been succinctly stated by Professor Weisbach:

[B]ifurcation creates the fewest arbitrages of any method of taxing hybrids. A nonbifurcation method of taxing hybrids, by definition, produces a tax on the hybrid different from the tax on any set of instruments with equivalent cash flows. Therefore, under any system other than bifurcation, taxpayers can hold or sell the hybrid and the components in the right combination to create an arbitrage that would not exist under bifurcation. While arbitrages exist under current law, financial innovation should not extend these arbitrages.<sup>217</sup>

Professor Weisbach acknowledges that bifurcation does not come without difficulties, one of which is the fact that with many transactions, there may not be a single bifurcation, but several possibilities. Though the FASB staff has dealt with multiple embedded derivatives, it has not, to this author's knowledge, analyzed a situation where there might be a choice as to which of several derivatives should be extracted from a hybrid instrument.<sup>218</sup>

A number of modifications would be necessary to the financial accounting system. Particularly if all financial transactions were not automatically marked to market, the IRS, for instance, would have to have the authority to identify transactions as hedges, and thereby require that

---

<sup>217</sup> Weisbach, *supra* note 1, at 526.

<sup>218</sup> Presumably, removing all "derivative features" is supposed to resolve this issue. The statement in the text may soon have to be qualified if certain trends in the analyses of the Derivatives Implementation Group continue. With Issue No. B 20 on embedded derivatives, the Group asked the question: Must the terms of a separate non-option embedded derivative produce a zero fair value at inception? The FASB staff concluded that the answer to the question is yes. "If a non-option embedded derivative has stated terms that are off-market at inception, that amount should be quantified and allocated to the host contract since it effectively represents a borrowing . . . ." In Implementation Issue No. B 22, the Group reached the opposite conclusion as to an option-based embedded derivative. Thus, such an "option" need not have a strike price equal to the market price of the underlying at inception. The tentative response noted: "There are substantive, fundamental differences between forward-based and option-based contracts. Adjusting the strike price of an option-based embedded derivative fundamentally alters the economics of the hybrid instrument, whereas adjusting the strike price of a forward-based embedded derivative does not necessarily fundamentally alter the economics of the hybrid instrument . . . ." See also Implementation Issue No. B 24.

the hedged instrument be marked to market. It is not clear that the FASB's insistence on extracting the derivative component of any hybrid instrument necessarily achieves a better valuation than an integrated analysis approach. It may be that the integrated treatment of contingent payment debt instruments achieves a better result for the fisc than an approach that separates the hybrid into straight debt and a forward (for instance). The sophisticated structured notes that take advantage of the possible tax characterizations of the transactions may only be reclaiming some of what was precluded by the contingent payment debt regulations, and what is limited by the Treasury Regulations 1.1275-6 and 1.988-5 hedge approaches.

It is also to be noted that changing to fair value accounting for tax purposes is less neutral with regard to cash flows than changing to fair value accounting for financial reporting. Tax consequences of fair value measurement may directly affect cash flows and may force a taxpayer to change cash management practices. The taxpayer may have to increase its borrowing. For instance, if the taxpayer's tax liability under historical cost is \$100 in Year One and \$200 in Year Two, a change to fair-value tax accounting might mean that the tax liability would be accelerated to \$200 in Year One and \$100 in Year Two. The taxpayer may have to borrow an additional \$100 in Year One to pay its taxes. This argues that, politically, a reduction of rates may be a necessary adjunct to the broad adoption of a fair value tax system.

#### XIV. CONCLUSION

The financial accounting system introduced by SFAS 133 is a partial bifurcation, nearly full mark-to-market system. The mark-to-market approach will be even more complete if current initiatives to require marking all financial instruments to market are implemented. Implementing a broad mark-to-market tax system is often assumed to be a form of political suicide, though coupled with a large rate cut it *might* be palatable. Valuation is less of a problem than it once was, due largely to the increasing sophistication of software for financial instrument valuation and the firm-wide risk assessments required by various regulators.

Peter Schickele's PDQ Bach wrote a concerto for piano *vs.* orchestra (S. 88), in which the pianist and the orchestra sometimes seem to be going more or less in the same direction, sometimes ignore each other, and sometimes become visibly hostile to each other. At one point the soloist refuses to continue unless a particular member of the orchestra is ejected from the stage. The audience (at least this viewer, who makes no pretenses to being a music critic) tries to enjoy the music, but inevitably becomes more focused on the drama of conflicting musical wills. Tax accounting for derivatives and hedges sometimes harmonizes with financial accounting, sometimes seems more or less developed than its financial

counterpart, and sometimes seems downright at odds with it. In the meantime, taxpayers and shareholders struggle to understand why two systems with so many overlapping terms and concepts can reach such discordant results. The two conceptions can come closer, but whether they will or not may depend on whether Congress can give up some of the history that has put so many conflicting and confusing layers in the tax law. That may depend on the public's ability to accept a system that abandons an almost religious belief in the realization as a precursor to recognition.

The tax system has evolved in response to specific transactions, waiting for financial innovation to provide new questions and to suggest new solutions. The approach of SFAS 133, and current initiatives to broaden fair value financial accounting, provides a structure that covers most present and future financial structures. Where financial transactions fall between over-the-counter and exchange traded instruments, between debt and equity, between ordinary activities and capital assets, between present contracts and anticipated transactions, tax-savvy designers can perhaps too easily choose between tax regimes. The cat and mouse game continues, and Congress and the tax regulators fill the holes one at a time. The question then becomes, not quite what was posed at the beginning—whether financial accounting can be the basis of a tax accounting system, but whether it is appropriate to step back and say, “Now has come the time to rethink the entire tax system relative to financial transactions.” The rate of innovation makes it impossible for regulatory refinement to keep up with the holes that the mice chew in the walls. Some guidance may come from SFAS 133 and the FASB initiatives, but some of the tax system has proven effective and resilient, and may harmonize very well indeed with a new approach.