Florida Tax Review

Volume 19 | Article 10

2023

The Tax Hedging Rules Revisited

Dr. Yoram Keinan

Follow this and additional works at: https://scholarship.law.ufl.edu/ftr

Recommended Citation

Keinan, Dr. Yoram (2023) "The Tax Hedging Rules Revisited," *Florida Tax Review*: Vol. 19, Article 10.
Available at: https://scholarship.law.ufl.edu/ftr/vol19/iss1/10

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in Florida Tax Review by an authorized editor of UF Law Scholarship Repository. For more information, please contact jessicaejoseph@law.ufl.edu.

FLORIDA TAX REVIEW

Volume 19 | *2016* | *Number 10*

THE TAX HEDGING RULES REVISITED

by

Dr. Yoram Keinan [*]

ABSTRACT

As more and more taxpayers (businesses and individuals) are exposed to market risks (including but not limited to fluctuations in interest rates, foreign currency exchange rates and prices), management of such risks has become more and more important for a growing number of taxpayers. To mitigate the potential impact of such market risks, taxpayers enter into hedging transactions (mostly derivatives) to manage such risks. Typically, to manage the risk effectively, the hedging transactions would involve offsetting (i.e., long and short) positions with respect to the same or similar property, so that normally, when one position appreciates the other depreciates (and vice versa). In addition, hedging transactions frequently involve periodic payments (for example, periodic swap payments) either made or received by the taxpayer, depending on movement in market prices or interest rates. Furthermore, a termination payment (again, either made or received by the taxpayer) is typically made when the transaction matures or terminated earlier.

From a tax perspective, taxpayers seek effective matching of character and timing of income and deductions from the hedging transaction (both periodic and termination payments) and the hedged item; otherwise, the economic benefit of the risk management strategy will be offset (and perhaps completely negated) by the tax inefficiency created as a result of the mismatch. As I argue in this article, our government should encourage taxpayers to exercise risk management and therefore, should accommodate tax efficiency by reducing the potential for character and timing mismatches. As of now, however, the U.S. federal income tax regime pertaining to hedging transactions limits the availability of the matching principle in certain ways,

[*]Partner at Smith Gambrell & Russell, LLP in New York City; J.S.D., 2002 University of Michigan Law School; M.P.A., 2001 International Taxation, Harvard University, John F. Kennedy School of Government; LL.M., 2001 University of Michigan Law School; I.T.P., 2000 International Taxation, Harvard Law School; M.B.A., 1998 Bar-Ilan University; LL.M., 1998 Hebrew University School of Law; LL.B., 1995 Tel Aviv University; B.A., 1995 Tel Aviv University.

the result of which is that many transactions with a purpose of risk management remain outside the scope of the tax hedging rules. The current U.S. tax hedging rules suffer from several flaws and are not accommodating enough to many taxpayers. An immediate reform of the tax hedging rules is necessary.

INTRODUCTION 591
I. OVERVIEW AND HISTORY 592
A. *Corn Products* 593
B. *Arkansas Best Corp.* 594
C. *Federal National Mortgage Association v. Commissioner* 595
D. *The Treasury Regulations* 595
E. *Section 1221(a)(7)* 596
II. THE CURRENT TAX HEDGING RULES 597
A. *Definition, Scope and Exceptions* 597
B. *Risk Management* 598
C. *The Hedging Character Regulations* 599
D. *The Hedging Timing Rules* 599
1. *General* 599
2. *Particular Timing Scenarios* 601
a. *Hedges of Items Marked-to-Market* 601
b. *Hedges of Aggregate Risk* 601
c. *Hedges of Inventory* 602
d. *Hedges of Debt Instruments* 602
e. *Disposition of a Hedged Asset or Liability* 603
f. *Recycled Tax Hedges* 603
g. *Anticipatory Tax Hedges When the Anticipated Transaction Is Unfulfilled* 603
E. *Identification and Recordkeeping* 603
F. *Hedge of Debt Instruments* 605
1. *Debt Instruments to Be Issued in the Future* 605
2. *Hedging of Existing Debt* 606
3. *The Timing Rules for Hedges of Debt Instruments* 606
4. *Hedging Debt Instruments with Notional Principal Contracts* 607
a. *General* 607
b. *Periodic Payments* 607
c. *Swap Termination Payments* 608

d. Hedging Debt Instruments with Caps 609
5. Integration of a Debt Instruments with a Hedge 611
G. Consolidated Return Hedging 612
II. STRADDLES (SECTION 1092) 614
a. General 614
b. Scope and Definitions 615
c. Consequences of a Straddle 616
d. Identified Straddles 617
e. *Qualified Covered Calls* 619
III. MARK-TO-MARKET 619
a. Section 1256 619
b. Section 475: Mark-to-Market for Dealers and Electing Traders in Securities 622
c. Summary 624
IV. THE WAYS AND MEANS COMMITTEE'S PROPOSED REFORM FOR DERIVATIVES 625
a. Overview 625
b. Mark-to-Market Treatment for Derivatives 625
i. General 625
ii. Overview of the Proposed Mark-to-Market Rules 626
iii. Fair Market Value 626
iv. Definition of Derivative 627
v. Embedded Derivatives 627
c. Proposed Consolidation of Tax and GAAP Hedging Identification Rules 628
V. THE PROBLEMS WITH THE CURRENT TAX HEDGING RULES 628
a. Limited Scope 628
b. Gap Hedges 630
c. Book-Tax Nonconformity 632
i. Overview 632
ii. General Discussion of Accounting Principles Pertaining to Hedging 632
1. Fair Value Hedges 633
2. Cash Flow Hedges 633
3. Foreign Currency Hedges 633

4. *Definition of "a Derivative"* 634
5. *Effectiveness Requirement* 634
iii. *Conclusions* 634
d. *Uncertain Timing Rules* 635
e. *Swaptions as Example of Uncertain Timing Rules* 636
f. *Hedges Versus Straddles* 637
g. *Tax Hedge Identification Rules Are Too Strict* 638
VI. PROPOSED REFORM OF THE TAX HEDGING RULES 640
a. *Conform Book and Tax Hedging Treatment* 640
i. *Scope* 640
ii. *Timing* 641
iii. *Identification* 642
b. *Expand the Scope of the Definition of "Hedging Transaction" to Include Capital Assets* 643
c. *Exclusion from the Straddle Rules for Economic Hedges* 644
VII. CONCLUSION 645

INTRODUCTION

As more and more taxpayers (businesses and individuals) are exposed to market risks (including but not limited to fluctuations in interest rates, foreign currency exchange rates and prices), management of such risks has become more and more important for a growing number of taxpayers. To mitigate the potential impact of such market risks, taxpayers enter into hedging transactions (mostly derivatives) to manage such risks. Typically, to manage the risk effectively, the hedging transactions would involve offsetting (i.e., long and short) positions with respect to the same or similar property, so that normally, when one position appreciates the other depreciates (and *vice versa*). In addition, hedging transactions frequently involve periodic payments (for example, periodic swap payments) either made or received by the taxpayer, depending on movement in market prices or interest rates. Furthermore, a termination payment (again, either made or received by the taxpayer) is typically made when the transaction matures or terminated earlier.

From a tax perspective, taxpayers seek effective matching of character and timing of income and deductions from the hedging transaction (both periodic and termination payments) and the hedged item; otherwise, the economic benefit of the risk management strategy will be offset (and perhaps completely negated) by the tax inefficiency created as a result of the mismatch.

As I argue in this article, our government should encourage taxpayers to exercise risk management and therefore, should accommodate tax efficiency by reducing the potential for character and timing mismatches. As

of now, however, the U.S. federal income tax regime pertaining to hedging transactions limits the availability of the matching principle in certain ways, the result of which is that many transactions with a purpose of risk management remain outside the scope of the tax hedging rules.

For example, X is a corn processor that uses grain corn to manufacture products such as cornstarch. On July 1, 2015, X enters into a contract to deliver to a customer a fixed quantity of starch at a fixed price on October 1, 2015. Because of limited storage space, X will not purchase the corn needed to fulfill the starch contract until September 2015. If the market price of corn increases between July 2015 and September 2015, X's profit on the starch contract would be reduced or eliminated.

To protect itself against such risk, X enters into a long futures contract on corn (e.g., a contract to buy corn). In September 2015, X will buy and take physical delivery of the corn needed to fulfill the starch contract, and at the same time settle the futures contract by either making or receiving a termination payment of cash. The amount paid or received to terminate the futures contract will offset a decrease or increase in X's cost of corn, and thus profit on the starch contract. As a result, X has effectively locked in the future purchase price of the corn needed to fulfill the customer order, and X's profit will not be affected by changes in the price of corn.

As set forth in more details in the article, such a transaction should, substantively, satisfy the current hedging rules. Nevertheless, if, X does not properly identify the futures contract as a hedging transaction for tax purposes (as well as the hedged item), it may encounter a character mismatch, whereby gains on one position are treated as ordinary income and losses on the other position are treated as capital losses and *vice versa*.

Therefore, in order for a taxpayer to avoid character and timing mismatches with respect to its hedging transactions, the taxpayer must adhere to the tax hedging rules. Otherwise, the tax inefficiency may outweigh the risk mitigation benefit of entering into the offsetting positions. Nevertheless, as I argue in this article, the current U.S. tax hedging rules suffer from several flaws and are not accommodating enough to many taxpayers. Thus, an immediate reform of the tax hedging rules is necessary.

This article begins with an overview of the general principles relating to tax hedging transactions, presents the flaws of the current regime, and sets forth a comprehensive proposal for reform.

I. Overview and History

For many years, taxpayers have been managing risks related to movements in commodities and securities prices, foreign exchange currencies,

and interest rates.[1] The vast majority of instruments that are available to manage such risks are derivatives, including options, futures, forward contracts, and notional principal contracts. Short sales are also used as hedging tools.

In general, taxpayers that manage risk with hedging transaction have three tax-related goals: (1) matching the timing and character of the gain and loss from the hedging transaction with any loss or gain on the hedged item;[2] (2) matching the financial accounting and tax income and expenses to minimize compliance burdens; and (3) avoiding the straddle rules (as well as other possible anti-abuse rules).

Prior to 1994, the tax treatment of hedging transactions was entirely a matter of case law and administrative practice. However, the cases (discussed immediately below) focused primarily on the potential character mismatch and not on timing.

A. *Corn Products*

In *Corn Products* the taxpayer was, as the case name indicates,[3] a manufacturer of corn products. To protect itself against the risk of fluctuations in the price of corn, the taxpayer engaged in the purchase and sale of corn futures. The taxpayer argued that the corn futures were capital assets and that profit and losses from their sale were entitled to preferential tax treatment under the capital assets provisions. The Supreme Court found that the future transactions constituted "an integral part of its manufacturing business," and the gains and losses were given ordinary tax treatment.

Specifically, the Supreme Court stated that:

> Congress intended that profits and losses arising from the every-day operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by [section 1221] applies to transactions in property which are not the normal source of business income. It was intended "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be

---

1. Corn Products Refining Co. v. Comm'r, 350 U.S. 46 (1955).
2. If the hedge is effective, one position should have gain while the offsetting position will have loss.
3. 350 U.S. at 46.

> narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose. This Court has always construed narrowly the term "capital assets" in [section 1221].[4]

B. *Arkansas Best Corp.*

In 1988, the Supreme Court in *Arkansas Best*[5] held that gain or loss on the sale or exchange of an asset is capital unless the asset falls within one of the specifically enumerated exceptions in section 1221. The taxpayer was a holding company that acquired 65% of the stock of a bank in 1968. The taxpayer had hopes of selling the shares at a profit and had acquired additional shares in the bank between 1973 and 1976. In order to comply with federal legislation, the taxpayer sold a 51% block of the stock of its bank subsidiary in 1975 and the remaining 14% over the next several years at a loss. The holding company claimed a deduction for an ordinary loss resulting from the sale of the bank stock.

The Tax Court had held that the bank stock was originally acquired as an investment and that the loss constituted a capital loss.[6] The additional bank stock purchased by the holding company, however, was treated by the Tax Court as held for a business purpose and was an ordinary asset, loss on the sale of which should be treated as ordinary loss.[7]

On appeal, the Eighth Circuit reversed in part and held that regardless of the purpose for which it was acquired, all of the bank's stock should be treated as a capital asset, and all of the bank's stock fell outside any of the specific statutory exceptions.[8]

Finally, the U.S. Supreme Court affirmed and held that all assets are capital unless they are enumerated in section 1221(a). The court however, agreed with the statement in *Corn Products Refining Co.* that "the definition of 'capital asset' must be narrowly applied and its exclusions interpreted broadly."[9] In other words, the Supreme Court has confirmed that while ordinary treatment should be reserved only to the enumerated exceptions, these exceptions should be interpreted broadly.

---

4. *Id.* at 52 (quoting Burnet v. Harmel, 287 U.S. 103, 106 (1932)) (omission in original).
5. Ark. Best Corp. v. Comm'r, 485 U.S. 212 (1988).
6. Ark. Best Corp. v. Comm'r, 83 T.C. 640, 654–55 (1984).
7. *Id.* at 656–57.
8. Ark. Best Corp. v. Comm'r, 800 F.2d 215, 218–21 (8th Cir. 1986).
9. *Ark. Best*, 485 U.S. at 220.

C. Federal National Mortgage Association v. Commissioner

Five years later, the Internal Revenue Service (the "Service") argued that *Arkansas Best Corp.* required the taxpayer to treat its hedging losses as capital, but the Tax Court disagreed and held for the taxpayer,[10] the Federal National Mortgage Association (FNMA), which is a publicly held corporation organized under federal law. FNMA was established for the purpose of providing liquidity to the secondary market for home mortgages.[11] FNMA offered commitments to purchase mortgages for a price fixed on the commitment date. To manage a portion of its interest rate exposure, FNMA entered into certain hedging transactions.[12] During the years 1984–1985, interest rates generally declined, and FNMA suffered substantial hedging losses.[13] The question arose whether those hedging losses were capital or ordinary. The Tax Court held that the hedging losses should be treated as ordinary losses.[14]

The Tax Court emphasized, however, that the taxpayer's mortgage loans were ordinary assets under section 1221(a)(4). The Tax Court explained that mortgages purchased by FNMA constituted ordinary assets under section 1221(a)(4) because FNMA provides services to the market by virtue of providing liquidity.[15]

D. The Treasury Regulations

In 1993, the Service issued temporary hedging regulations and a year later, followed with final regulations. The hedging regulations include timing rules[16] and character rules.[17] To qualify for tax hedging treatment under the Regulations, the taxpayer must satisfy both substantive and procedural requirements: (1) substantive requirement—the hedged items must be ordinary (or borrowings), and the hedging transaction must be entered into in the taxpayer's normal course of business to manage interest rate risk associated with these hedged items; and (2) procedural requirement—the hedging transaction must be properly and timely identified.[18]

---

10. Fed. Nat'l Mortg. Ass'n v. Comm'r*,* 100 T.C. 541 (1993).
11. *Id.* at 545.
12. *Id.* at 547–48.
13 *Id.* at 548.
14. *Id.* at 579.
15. *Id.*
16. Reg. § 1.446–4.
17. Reg. § 1.1221–2. Any item of income, deduction, gain, or loss stemming from a hedging transaction is ordinary.
18. Reg. § 1.1221–2(b) to (d), (f).

E. Section 1221(a)(7)

Under general tax principles, capital gain/loss treatment applies to gain or loss on the sale or exchange of a "capital asset."[19] For this purpose, section 1221(a) provides that the term "capital asset" means property held by the taxpayer (whether or not connected with his/her trade or business), but does not include certain classes of enumerated properties (set forth in subsection (1)–(8) of section 1221(a)), which include, among other things, property that is part of a "hedging transaction," which is clearly identified as such "before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe)."[20]

Section 1221(a)(7) was added to the Code in 1999 (five years after the regulations) to "codify" the ordinary treatment of hedging transactions by enumerating a "hedging transaction" as one of the eight categories of properties that are not "capital assets."[21]

The term "hedging transaction" is defined for this purpose in section 1221(b)(2)(A) and Regulations section 1.1221–2(b) as any transaction entered into by a taxpayer in the normal course of the taxpayer's trade or business primarily to manage the risks specified in section 1221(b)(2)(A)(i) through (iii). Importantly, the tax hedging rules only apply to transactions entered into in a taxpayer's ordinary course of a trade or business. Because only ordinary assets (and certain liabilities) can be hedged, pursuant to the matching principle, gain or loss on a properly identified hedging transaction is treated as ordinary.[22]

While the statute generally followed the Regulations under section 1221 in defining a "hedging transaction," Congress made a significant modification to the definition contained in those regulations. Under the

---

19. I.R.C. § 1001(a).

20. I.R.C. § 1221(a)(7), which was added to the Code effective December 17, 1999. Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 532(a)(1)–(3), 113 Stat. 1860, 1929.

21. The 1999 Tax Act added three categories to the list of assets that will not be considered capital assets under I.R.C. § 1221: (1) commodities derivative financial instruments held by commodities derivatives dealers; (2) "hedging transactions"; and (3) supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business. § 532(a), 113 Stat. at 1928–29.

22. Certain other Code sections also treat gains or losses as ordinary. For example, the gains or losses of securities dealers or certain electing commodities dealers or electing traders in securities or commodities that are subject to "mark-to-market" accounting are treated as ordinary. I.R.C. § 475.

previous regulations, a hedging transaction had to "reduce risk."[23] Under the statute, the risk reduction standard was broadened to cover transactions entered into to "manage risk" with respect to ordinary property held (or to be held) by the taxpayer or certain liabilities incurred (or to be incurred) by the taxpayer, and the definition of a hedging transaction includes a transaction entered into primarily to manage such other risks as the Secretary may prescribe in regulations.[24]

II. THE CURRENT TAX HEDGING RULES

A. Definition, Scope and Exceptions

For tax purposes, a hedging transaction is a transaction: (1) entered into in the normal course of a taxpayer's business, primarily (2) to manage the risk of (a) price changes, or (b) currency fluctuations with respect to "ordinary property" held or to be held by the taxpayer; or (c) to manage the risk of interest rate changes, 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.[25]

For this purpose, an obligation is an "ordinary obligation" if performance or termination by the taxpayer could not produce capital gain or loss.[26] Importantly, a transaction that manages an "aggregate risk" of interest rate changes, price changes and/or currency fluctuations can be a "hedging transaction" only if all of the risk, or all but a *de minimis* amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings.[27]

The above definition of a "hedging transaction" addresses a transaction entered into by a taxpayer to manage the risk of *the same* taxpayer. However, this requirement has been modified (and expanded) for hedging transactions entered into by members of a consolidated return group.[28]

In terms of exceptions, Regulations section 1.1221–2(d)(5) provides that

> [T]he purchase or sale of a debt instrument, an equity security, or an annuity contract is not a hedging transaction even if the transaction limits or reduces the taxpayer's risk with respect to ordinary property, borrowings, or ordinary obligations. In addition, the [Service] may determine in published guidance that other transactions are not hedging transactions.

---

23. T.D. 8493, 1993–2 C.B. 255, 257–58.
24. I.R.C. § 1221(b)(2)(A).
25. *Id.*; Reg. § 1.1221–2(b).
26. Reg. § 1.1221–2(c)(2).
27. Reg. § 1.1221–2(c)(3).
28. Reg. § 1.1221–2(e).

Thus, the acquisition of these specified assets *per se* cannot constitute hedging transactions, even if they meet the functional risk management requirement for hedging transactions. As a result, it typically will be very difficult to establish to the satisfaction of the Service that an investment is purchased, or debt is issued, primarily to manage risk for purposes of the hedging rules. As an illustration of this *per se* rule, the hedging regulations offer an example of an employer with a deferred compensation liability determined by reference to the performance of shares in a mutual fund that hedges its liability by directly purchasing shares in that same mutual fund. The example concludes that the purchased shares cannot qualify as a hedging transaction.[29]

Additional relevant exceptions from the hedging rules include: (1) a position to which section 475(a) (positions held by a dealer and electing trader in securities and commodities) applies; (2) a transaction that is integrated under Regulations section 1.1275–6; and (3) certain foreign currency (section 988) transactions.

B. Risk Management

As set forth above, the 1999 enactment of section 1221(a)(7) expanded the "risk reduction" concept to "risk management."[30] In general, whether a transaction is entered into primarily to "manage risk" of the taxpayer will be determined based on all of the facts and circumstances surrounding the transaction and the taxpayer's business (including the taxpayer's hedging strategies and policies as reflected in the taxpayer's records).[31]

In addition to establishing that the hedging transaction manages the risk associated with a particular ordinary asset, borrowing, or other position, the taxpayer must establish that the transaction manages risk at an enterprise-wide or smaller business unit level (or at a consolidated group level under the consolidated return hedging rules as discussed below) in light of all operations, assets, and liabilities.[32]

If a position is not entered into by the taxpayer primarily to manage risk, the transaction is not a hedging transaction, even if the terms of the transaction happen to manage the taxpayer's risk with respect to other assets or liabilities. The taxpayer's burden of proof in this regard is lightened where the hedging transaction is undertaken as part of a program of overall risk management:

29. Reg. § 1.1221–2(d)(5)(ii), Exs. 2–3.
30. *See supra* notes 21–24 and accompanying text.
31. Reg. § 1.1221–2(c)(4)(i).
32. *Id.*; Reg. § 1.1221–2(d)(1)(ii)(B).

> If a taxpayer hedges particular assets or liabilities, or groups of assets or liabilities, and the hedges are undertaken as part of a program that, as a whole, is reasonably expected to reduce the overall risk of the taxpayer's operations, the taxpayer generally does not have to demonstrate that each hedge that was entered into pursuant to the program reduces its overall risk.[33]

C. *The Hedging Character Regulations*

The general purpose of sections 1221(a)(7) and 1221(b)(2) is to address the character of income or loss of a hedging transaction.[34] Specifically, these sections match the character of income and deductions from the hedging transaction with income and deductions on the hedged item in a manner that is generally advantageous to taxpayers. The character of a hedging transaction is determined pursuant to Regulations section 1.1221–2(a), which provides that the term "capital asset" does not include property that is part of a hedging transaction.

Obviously, because a taxpayer can only hedge ordinary property (and certain liabilities), any item of income, deduction, gain, or loss resulting from a hedging transaction is ordinary. Stated differently, if the requirements for a hedging transaction are met, section 1221(a)(7) provides that gains and losses on hedging transactions are ordinary.[35]

The significance of the hedging character regulations is that taxpayers can match ordinary gains with ordinary losses arising from the hedging transaction and hedged item, thereby avoiding a mismatch of ordinary gains with capital losses and *vice versa*. Nevertheless, as I argue in this article, the character matching principle should be expanded to hedging of capital assets.

D. *The Hedging Timing Rules*

1. *General*

The purpose of Regulations section 1.446–4 is to clearly reflect income by matching the timing of income, gain, loss, and deductions from a hedging transaction with income, gain, loss, and deductions from the corresponding hedged item. The matching-of-timing purpose is independent of character of income and loss.

---

33. Reg. § 1.1221–2(d)(1)(ii)(A).

34. I.R.C. § 1221(a)(7) sets forth the rule that a "hedging transaction" is ordinary, and I.R.C. § 1221(b)(2) defines the term "hedging transaction" for this purpose (and the timing hedging rules reference the same definition).

35. I.R.C. § 1221(a)(7); Reg. §1.1221–2.

The rules of Regulations section 1.446–4 control the timing of income, deduction, gain, or loss with respect to the hedging transaction and take precedence over the provisions of any other regulations that are inconsistent. Regulations section 1.446–4(a) provides that "a hedging transaction as defined in [Regulations section] 1.1221–2(b) (whether or not the character of the gain or loss from the transaction is determined under [Regulations section] 1.1221–2) must be accounted for under the rules of [Regulations section 1.446–4]." Thus, the definition of a "hedging transaction" is contained in the hedging character rules (discussed below), and the hedging timing rules reference the same definition.

Pursuant to the hedging timing rules, the taxpayer's method of accounting for a hedging transaction and hedged item must "clearly reflect income."[36] Accordingly, the accounting method used must "reasonably match" the timing of income, deduction, gain, or loss from the hedging transaction with income, deduction, gain, or loss from the hedged item.[37] Thus, taxpayers must choose a method of accounting that reasonably matches the timing of income/loss from the hedging transaction with the timing of income/loss from the hedged item.

Any gain or loss recognized on the disposition of a hedged item must be matched with, and adjusted for, unrealized gain or loss on hedging transaction.[38] More than one method of tax accounting may satisfy the clear reflection of income requirement in accordance with the matching requirement. Regulations section 1.446–4(c) establishes that the taxpayer has broad latitude to adopt a method of accounting for a hedging transaction; as long as the method of accounting for the hedging transaction follows the restrictions set forth in Regulations section 1.446–4(e) and clearly reflects income, it should be respected.

As Regulations section 1.446–4(c) acknowledges, "there may be more than one method of accounting that satisfies the clear reflection requirement." Furthermore, the regulations indicate that different methods of accounting

---

36. Reg. § 1.446–4(b) ("The method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. 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.").

37. *Id.*

38. Reg. §§ 1.446–4(b), (e).

may be adopted for different types of hedging transactions and for hedges of different types of hedged exposures. However, once adopted, such methods are binding on the taxpayers and, in general, may not be changed without the consent of the Service.[39]

Importantly, the hedging timing rules indicate that following generally accepted accounting principles (GAAP) will not, *per se*, clearly reflect income for federal income tax purposes. While the preamble to the regulations suggest that following GAAP may clearly reflect income in most circumstances,[40] as described in more detail below,[41] GAAP may diverge, sometimes significantly, from the reasonable matching principle applicable for U.S. federal income tax purposes.

2. Particular Timing Scenarios

The hedging timing rules provide specific guidance with respect to hedges of certain assets and liabilities. The regulations specifically address the types of hedging situations described immediately below.

a. Hedges of Items Marked-to-Market. Where the hedged item is marked to market under the taxpayer's regular method of accounting (e.g., if the taxpayer is a dealer), marking the hedging transaction to market clearly reflects income.[42] To emphasize, these situations are probably the only cases where the hedging transaction is marked to market because, as set forth below, hedging transactions are generally excluded from the scope of sections 475 and 1256.

b. Hedges of Aggregate Risk. In the case of hedges of aggregate risks, pursuant to Regulations section 1.446–4(e)(1)(i), a reasonable method of accounting must meet the matching requirements of Regulations section 1.446–4(b) by matching the timing of the income, deduction, gain, or loss from the hedging transaction with the timing of the aggregate income, deduction, gain, or loss from the items being hedged.

Under the so called "mark-and-spread" method, the taxpayer marks the hedging transaction to market at regular intervals (i.e., computes the

39. Reg. § 1.446–4(c).

40. T.D. 8554, 1994–2 C.B. 76, 76 ("Because the financial accounting standards for hedges are in a state of development, however, the final regulations do not expressly sanction the use of financial accounting methods. Nevertheless, the Service and Treasury expect that the hedge accounting methods employed by most taxpayers for financial accounting purposes will satisfy the clear reflection standard in the final regulations.").

41. *See infra* Part VI.C.

42. Reg. § 1.446–4(e)(2).

unrealized gain or loss that has accrued since the beginning of the interval) and amortizes the resulting gain or loss, together with any realized gain or loss, over the remaining period for which the hedging transaction is intended to manage risk.[43] The intervals used in applying the mark-and-spread method must be no longer than three months.

c. Hedges of Inventory. Gains and losses on inventory hedges may be taken into account in the same period that such amounts would have been taken into account if the gain or loss were treated as part of the cost of the inventory (for hedges of purchases) or as part of the sales proceeds (for hedges of anticipated sales). However, hedging gains and losses are not part of inventory cost or sales proceeds, as such.[44]

The regulations also suggest alternative methods. First, taxpayers (other than taxpayers that use the "last in first out," or "LIFO," method of accounting) may treat realized gains and losses on both hedges of inventory purchases and hedges of inventory sales as though they were elements of inventory cost in the period in which realized.[45]

Second, taxpayers (other than taxpayers that use either the LIFO method of accounting or the lower-of-cost-or-market method of accounting) may mark their hedging transactions to market (even though the hedged inventory is not marked-to-market) if items of inventory generally are held only a short time.[46] Finally, the "mark-and-spread" method described above may be applied if a transaction hedges a number of different purchases or sales of inventory over a particular time period.[47]

d. Hedges of Debt Instruments. Gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by the taxpayer, is to be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates.[48] Thus, such gain or loss generally would be taken into account as an adjustment to the yield of the debt instrument over the term to which the hedge relates (see detailed discussion below in Part II.F on hedging debt instruments).

---

43. Reg. § 1.446–4(e)(1).
44. Reg. § 1.446–4(e)(3)(i).
45. Reg. § 1.446–4(e)(3)(ii)(A).
46. Reg. § 1.446–4(e)(3)(ii)(B).
47. Reg. § 1.446–4(e)(3)(i).
48. Reg. § 1.446–4(e)(4).

e. Disposition of a Hedged Asset or Liability. If a taxpayer disposes of a hedged position or terminates its interest in the position but does not dispose of or terminate the tax hedge, the built-in gain or loss on the hedge must be appropriately matched with the gain or loss on the hedged item. The taxpayer may mark the hedging transaction to market to comply with this rule. Waiting until the hedging transaction is closed out is generally only appropriate if such an event occurs within seven days after disposition of the hedged item.[49]

f. Recycled Tax Hedges. A taxpayer must match the built-in gain or loss at the time of the recycling to the loss or gain on the original hedged item, presumably by marking the hedging transaction to market at that time.[50]

g. Anticipatory Tax Hedges When the Anticipated Transaction Is Unfulfilled. If a taxpayer enters into a hedging transaction to manage the risk with respect to an anticipated transaction, and the anticipated transaction is not consummated, the regulations require that any gain or loss from the hedging transaction must be taken into account when realized.[51]

E. Identification and Recordkeeping

A transaction that otherwise meets the definition of "hedging transaction" must be identified as a tax (separate from financial accounting) hedging transaction, no later than the close of the day on which the transaction is entered into.[52] The general requirements for a proper tax hedging identification, as required by section 1221(a)(7), are set forth in Regulations section 1.1221–2(f). Additional (and specific) identification requirements are set forth in Regulations section 1.446–4(d)(2). The identification must be unambiguous.

The hedged item or items must be identified within 35 days after the day on which the hedging transaction is entered into.[53] These identifications should be part of the taxpayer's permanent books and records.[54] Importantly,

49. Reg. § 1.446–4(e)(6).
50. Reg. § 1.446–4(e)(7).
51. Reg. § 1.446–4(e)(8).
52. Regs. §§ 1.1221–2(f)(1), –2(f)(4)(ii).
53. Reg. § 1.1221–2(f)(2). The regulations specify only that the identification must be made "substantially contemporaneously" with entering into the hedging transaction and that identification made more than 35 days after entering into the hedging transaction is not substantially contemporaneous. In the absence of guidance to the contrary, this regulation has been interpreted as treating identifications made with the 35-day period as being substantially contemporaneous. *See* Howard J. Rothman et al., *Capital Assets*, 561-3d TAX MGMT. PORT. (Bloomberg BNA) § XI.B.3.
54. Reg. § 1.1221–2(f)(4)(i).

as of now, the designation of a transaction as hedging transaction for financial accounting purposes does not satisfy the tax identification requirement unless the taxpayer's books and records indicate that the hedging transaction is also being identified for tax purposes.[55]

In general, the identification can be made for individual hedging transactions, or for a class or classes of hedging transactions that are identified for financial accounting or regulatory purposes, provided that the identifications indicate that they are also being made for tax purposes.[56]

A taxpayer may use a system in which identification is made based on the type of transaction entered into (e.g., a specific derivative product) where the books and records indicate that all such transactions are tax hedges.[57] Alternatively, a taxpayer may use an identification system in which tax hedging identification is made based on the manner in which the transaction is recorded (e.g., by posting the transaction to an account that has been identified as containing only tax hedges or by placing a designated mark on a record of the transaction or using a designated form that includes an appropriate legend to record the transaction).[58]

The regulations also impose additional specific identification requirements for certain types of hedging transactions. In the case of hedges of debt instruments to be issued, for example, the identification must specify the following expected information: (1) the date of issuance of the debt instrument; (2) the maturity date of the debt instrument; (3) the issue price of the debt instrument; (4) the particular interest provisions of the debt instrument; and (5) the amount or term being hedged. The identification may indicate ranges as opposed to specific dates, terms, or amounts.[59]

The regulations provide that, in general, a failure to identify a transaction as a hedging transaction is binding against both the Service and the taxpayer.[60] However, there are two exceptions to this general rule. The first one is an exception for an "inadvertent error" that can be relied on by taxpayers in certain circumstances.[61]

Pursuant to Regulations section 1.1221–2(g)(2)(ii), if a taxpayer does not properly and timely identify a qualified hedging transaction, the taxpayer may, but is not required to, treat gain or loss from the transaction as ordinary income or loss if each of the following requirements are satisfied: (1) the

---

55. Reg. § 1.1221–2(f)(4)(ii).
56. *Id.*
57. Reg. § 1.1221–2(f)(4)(iv)(B).
58. Reg. § 1.1221–2(f)(4)(iv)(A).
59. Reg. § 1.1221–2(f)(3)(iii)(B).
60. Reg. § 1.1221–2(g)(2)(i).
61. Reg. § 1.1221–2(g)(2)(ii).

transaction qualifies as a hedging transaction within the meaning of section 1221(b)(2); (2) the failure to identify the transaction was due to an "inadvertent error"; and (3) all of the taxpayer's other qualified hedging transactions in all open years are being treated on either original or, if necessary, amended returns, as qualified hedging transactions.[62]

The second exception is an anti-abuse rule that can be relied on by the Service.[63] This anti-abuse rule is designed to characterize gains from unidentified hedging transactions as ordinary while keeping any losses as capital if the taxpayer cannot establish a reasonable basis for not identifying the transaction as a hedging transaction. The taxpayer's financial accounting statement treatment of the transactions will be considered in determining if a reasonable basis for not identifying the transaction exists. This anti-abuse rule prevents a taxpayer from "electing" capital treatment for hedge gains.[64]

F. Hedge of Debt Instruments

Most hedges of debt instruments take one of three forms: (1) the taxpayer anticipates that it will need to incur long-term, fixed-rate debt in the future and wants to lock in the effective interest rate on that borrowing; (2) the taxpayer has outstanding an existing debt instrument that the taxpayer wants to convert, in effect, from fixed rate to floating-rate, or *vice versa*; or (3) an existing floating-rate debt as to which the taxpayer wants to cap its rate.

1. Debt Instruments to Be Issued in the Future

A taxpayer that plans to issue a fixed-rate debt instrument in the future may want to protect itself against the risk that interest rates increase or that foreign currency exchange rates fluctuate. What the taxpayer generally can do to manage such risks is (1) sell short a debt instrument of another issuer (typically shorting Treasuries); (2) enter into a forward starting interest rate swap with a cash settlement feature at the time the swap would otherwise go into effect; or (3) enter into a forward rate agreement pursuant to which it will receive or pay cash to make the effective cost of its borrowing a specified

---

62. *See, e.g.*, T.A.M. 2005–10–028 (Dec. 17, 2004) ("Where a failure to identify a hedging transaction is inadvertent and certain specified requirements have been satisfied, a taxpayer may, but is not required, to treat gain or loss from a hedging transaction as ordinary income or loss under Treas. Reg. 1.1221-2(a)(1) and (2).").

63. Reg. § 1.1221–2(g)(2)(iii).

64. *Id.* These regulations were amended in 2002. *See* T.D. 8985, 2002–1 C.B. 707. The prior version prohibited the election of character of losses as well as gains. *See* T.D. 8555, 1994–2 C.B. 180, 186. The preamble to the 2002 amendments offers no further guidance on this apparent change in policy. T.D. 8985, 2002–1 C.B. 707, 707–09.

target rate. Typically, the issuer will terminate the hedging transaction when it issues the debt instrument.

2. *Hedging of Existing Debt*

A borrower typically has a choice as to the term of the debt instrument and whether interest on the debt instrument is to be at a fixed or floating rate. A floating-rate debt instrument is typically cheaper in the short run and can become even cheaper if interest rates drop, but floating-rate debt presents the risk that interest rates will rise rapidly. The value of a floating-rate debt instrument is largely unaffected by changes in interest rates; however, there is a direct relationship between increases in market interest rates and the interest payable on the debt instrument

A fixed-rate debt instrument, on the other hand, provides the borrower with stable cash outflow, but locks the borrower in for the term of the debt instrument. If market interest rates fall, or even rise slowly, the fixed-rate borrower can be locked into higher financing costs, in comparison with other borrowers. There is an inverse relationship between the value of the debt and prevailing market interest rates: when market interest rates rise, the value of the debt instrument falls and *vice versa*.

> *Example: Hedge of Debt Instrument: Cash Flow Hedge.* G is the issuer of a five-year floating-rate debt instrument with a principal amount of $1 million, paying interest at LIBOR. G wishes to manage its risk with respect to fluctuations in the LIBOR rate. By entering into an interest rate swap with a notional amount of $1 million, where it will pay fixed rate of 5% and receive LIBOR, G's costs become fixed at 5%. This type of a hedging transaction is a "cash flow hedge."

> *Example: Hedge of Debt Instrument: Fair Value Hedge.* On the other hand, H is the issuer of a $1 million principal amount of fixed-rate debt instrument paying interest at 5%. H wishes to hedge the risk of changes in value of the debt instrument. To manage risk with respect to changes in the fair value of the debt instrument (due to changes in the market rate), H will enter into an interest rate swap where he pays LIBOR on a $1 million notional amount and receives a fixed rate of 5%. In this case, the hedging transaction will be a "fair value hedge."

3. *The Timing Rules for Hedges of Debt Instruments*

Gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by the taxpayer, must be accounted for by reference to the terms of the debt

instrument and to the period or periods to which the hedge relates.[65] Gain or loss on a transaction that hedges an anticipated fixed-rate borrowing for its entire term is accounted for as if it decreased or increased the issue price of the debt.[66] Thus, such gain or loss generally would be taken into account as an adjustment to the yield of the debt instrument over the term to which the hedge relates. If the debt instrument issuance is not "consummated," the taxpayer takes into account any income or loss from the transaction when realized.[67]

4. *Hedging Debt Instruments with Notional Principal Contracts*

a. General. Regulations section 1.446–3 addresses the timing of payments made or received pursuant to a notional principal contract. The hedge timing rules provide that the provisions of the separate notional principal contracts regulations govern the timing of income and deductions of notional principal contracts that are hedging transactions, unless the application of those regulations does not clearly reflect income in accordance with the matching rule as noted above, which should normally not be the case.[68]

In situations where a notional principal contract hedges a debt instrument, the general rules of accounting for periodic payments and the alternative methods for non-periodic payments (i.e., those based on constant yield principles) generally are considered to clearly reflect the taxpayer's income.[69]

However, the general methods for non-periodic payments (i.e., those based on allocating non-periodic payments in accordance with a series of cash-settled forward/option contracts) and the method for termination payments (i.e., requiring gain or loss to be recognized upon termination) generally do not clearly reflect a taxpayer's income if the notional principal contract is used to hedge a debt instrument.[70]

b. Periodic Payments. When an issuer of a debt instrument enters into an interest rate swap to hedge the risk with respect to the debt instrument, generally the hedging treatment of the swap initially has no effect on the timing and character of income and deductions from the debt.

With respect to character, the interest payments on the debt instrument as well as the periodic payments on the swap are treated as ordinary income or expense, whether or not the swap qualifies as a hedge for tax purposes, and

---

65. Reg. § 1.446–4(e)(4).

66. *Id.*

67. Reg. § 1.446–4(e)(8)(i).

68. Reg. § 1.446–4(e)(5).

69. *Id.* Specifically, regulations provide for alternative methods for swaps and caps that hedge debt instruments. Reg. §§ 1.446–3(f)(2)(iii), (v).

70. *Id.* (referencing the methods set forth in Reg. §§ 1.446–3(f)(2)(ii), (iv)).

there is no gain or loss to recognize if the swap stays outstanding for its full term. In this case, periodic income and expenses from the swap and debt will have the same character.

Similarly, with respect to timing, the periodic payments on the swap are taken into account on a current basis under the taxpayer's regular method of accounting, which is also true of the interest on the debt. As a result, with or without hedge treatment, the timing of the income or expense on the swap reasonably matches the timing of the income or expense on the debt instrument being hedged, and all periodic payments with respect to the swap and interest on the debt instrument will be ordinary.

Matching can be achieved even if the term of the swap is shorter than the term of the debt instrument. For example, if a borrower has issued a ten-year floating-rate debt and wants to lock in its borrowing costs for the first three years by entering into a three-year interest rate swap under which it is paying fixed and receiving floating, the issuer simply deducts or includes the payments on the swap in the periods to which they relate (provided the borrower specifies that the swap hedges only those first three years of the debt term).

c. Swap Termination Payments. The accounting method for termination payments (i.e., requiring gain or loss to be recognized upon termination of the swap) generally does not clearly reflect a taxpayer's income if the notional principal contract is used to hedge a debt instrument.[71] A particular issue arises when a taxpayer hedges a debt instrument with a notional principal contract and then terminates the hedging transaction prior to the maturity of the debt instrument.

In Revenue Ruling 2002–71,[72] the Service provided guidance on the timing of hedge gains and losses in two situations involving a taxpayer who issues a ten-year fixed-rate debt instrument and who simultaneously enters into a five-year swap that has a notional principal amount equal to the principal amount of the debt instrument. The taxpayer is thus synthetically converting the first five years of payments on the debt instrument into floating-rate payments. The taxpayer properly identifies the swap as a hedging transaction covering the first five years of the debt instrument.

In Situation 1, the taxpayer terminates the swap after two years and either makes or receives a termination payment. The facts are the same in Situation 2, except that, in addition, the taxpayer retires the debt instrument after four years. The ruling holds that in Situation 1, the taxpayer must spread the gain or loss from the termination payment over the remaining three years on the swap (not the remaining eight years of the underlying debt instrument).

71. Reg. §§ 1.446–3(f)(2)(ii), (iv).
72. Rev. Rul. 2002–71, 2002–2 C.B. 763.

In Situation 2, the portion of the gain or loss not amortized by the time the debt instrument is retired is taken into account in the year in which the debt instrument is retired.

> *Example: Swap Entered into During the Term of the Debt and Terminated Prior to Maturity.* A corporation issues $10 million of debt instruments with a term of ten years, paying semiannual interest at a fixed rate of 8%. The debt instruments are issued for par. When the debt instruments have seven years remaining and are still trading for their face amount, the issuer enters into a swap with a term of seven years and a notional principal amount of $10 million under which the corporation receives a fixed rate of 6.5% and pays a floating rate of six-month LIBOR. Two years later, the debt instruments are trading at a price of 108.53%, reflecting a yield to maturity of 6%. The issuer decides to terminate the swap and receives a payment of $800,000 from its counterparty for doing so. The corporation has an unrealized loss on its debt instrument of $853,000, which is largely offset by the $800,000 gain on the swap. To clearly reflect income, the corporation should amortize the $800,000 gain into income as if it increased the adjusted issue price on its debt instruments to $10,800,000 (i.e., as if the debt instruments were reissued at a premium on the date the hedge was terminated). The yield on the hypothetical reissued debt instrument is 6.12%, and the corporation amortizes the $800,000 under the principles applicable to premium debt instruments, except that the hedge gain should be reported as a separate income item rather than as an offset to interest expense, as it would be reflected if it were true premium.

d. Hedging Debt Instruments with Caps. The regulations provide a special rule for interest rate caps that hedge debt instruments.[73] The alternative method for caps allows for the amortization of the premium on a cap or floor "that is entered into primarily to reduce risk with respect to a specific debt instrument or group of debt instruments held or issued by the taxpayer."[74] This alternative applies solely for purposes of determining timing of income and deductions under the agreement and cannot be used by a dealer in notional

73. Reg. § 1.446–3(f)(2)(v). For this purpose, there is no requirement that the debt being hedged be ordinary property, so a holder of floating-rate debt could use this alternative rule for a purchased floor, even if the debt being hedged is a capital asset.

74 Reg. § 1.446–3(f)(2)(iv).

principal contracts for caps or floors entered into or acquired in its capacity as a dealer.[75]

The special rule permits the cap premium to be amortized using a "level payment method."[76] In effect, the level-payment method allocates the cap under the same pattern as the payments of principal on a level-payment (self-amortizing) loan with a yield equal to a market rate of interest between the parties.[77] The regulations set forth two examples for caps, one for prepaid premium and one for premium paid in installments.

In the case of a prepaid cap, the upfront premium may be amortized using the level-payment method described above for swaps.[78]

> *Example: Prepaid Cap.* On January 1, 1995, F pays to E $600,000 as a cap premium. Under the cap agreement, E will make a payment to F each calendar quarter equal to one-fourth of the excess, if any, of three-month LIBOR over 9% with respect to a notional principal amount of $25 million. The cap is entered into by F primarily to manage risk with respect to a debt instrument that F issued. If F elects to amortize the cap premium using the alternative level-payment method, it would amortize the premium by assuming that the $600,000 is repaid in three equal annual payments of $241,269, assuming a discount rate of 10%. Each payment is divided into a time-value component and a principal component, which are set forth in the table below.

Year	Level payment	Time-value component	Principal component
1995	$241,269	$60,000	$181,269
1996	$241,269	$41,873	$418,731
1997	$241,269	$21,934	$219,335
Total	$723,807	$123,807	$600,000

75. Reg. § 1.446–3(f)(2)(v). Presumably, a dealer would account for its caps and floors on a mark-to-market method under I.R.C. § 475(a).

76 Reg. § 1.446–3(f)(2)(v)(A).

77. The rate should be lower because the obligor is the securities dealer, not the cap purchaser. If the cap purchaser cannot reasonably ascertain the dealer's rate, it would appear reasonable to spread the premium as if it were discount on the hedged debt. *Cf.* Reg. § 1.446–4(e)(4).

78. Reg. § 1.446–3(f)(4), Ex. 3.

The time-value components are used only to compute the ratable daily portions of the cap premium and are otherwise disregarded. The net of the ratable daily portion of the principal component and the payments, if any, received from E, comprise F's annual net income or net deduction from the cap.

5. *Integration of a Debt Instrument with a Hedge*

Special rules also apply to hedging transactions of debt instruments, where the hedging transaction and debt instrument are integrated.[79] Regulations provide for the integration of a "qualifying debt instrument" with a "section 1.1275–6 hedge" if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed- or variable-rate debt instrument.[80]

A qualifying debt instrument ("QDI") is any debt instrument, including a synthetic debt instrument arising from another integrated transaction, other than: (1) a tax-exempt obligation, as defined in section 1275(a)(3), (2) a debt instrument to which section 1272(a)(6) applies, or (3) a debt instrument that is subject to Regulations section 1.483–4 or Regulations section 1.1275–4(c) (certain contingent payment debt instruments issued for non-publicly traded property).[81]

A section 1.1275–6 hedge is any financial instrument if the combined cash flows of the QDI and the hedging instrument permit the calculation of a yield to maturity under the principles of section 1272, or the right to the combined cash flows would qualify as a variable-rate debt instrument ("VRDI") that pays interest at a qualified floating rate or rates.[82] A "financial instrument" is a spot, forward, or futures contract; an option; a notional principal contract; a debt instrument or a similar instrument; or combination or series of financial instruments. Stock is not a financial instrument for this purpose.[83]

The integration creates a "synthetic debt instrument," which is a hypothetical debt instrument with the same cash flows as the combined cash flows of the qualified debt instrument and the section 1.1275–6 hedge.[84]

---

79. *See* Reg. § 1.1275–6.
80. Reg. § 1.1275–6(a).
81. Reg. § 1.1275–6(b)(1).
82. Reg. § 1.1275–6(b)(2).
83. Reg. § 1.1275–6(b)(3).
84. Reg. § 1.1275–6(b)(4). A similar but separate set of rules exists with respect to integration of foreign currency-denominated debt instruments and hedges. *See* Reg. § 1.988–5.

> *Example: Debt Instrument Integrated with a Swap.* Holder's debt instrument: A five-year debt instrument with a $1,000 face value, receiving a coupon of 5% semiannually, issued on January 1, 2015. The debt instrument is a qualified debt instrument.
>
> Holder's swap: Five-year term, notional amount of $1,000, paying a fixed 5% and receiving LIBOR, every six months, entered into on January 1, 2015. The swap is a section 1.1275–6 hedge.
>
> Resulting synthetic debt: The holder is deemed to have a five-year VRDI receiving LIBOR semiannually.

Integration of a debt instrument with a purchased call option can allow the issuer/purchaser to deduct the premium paid for the call, as opposed to the normal case where the premium is not deductible until the call option is settled, sold, or lapses.

> *Example: Convertible Debt Integrated with a Call Option.* Company XYZ issues convertible debt instrument with a term of ten years, principal amount of $1,000 (issued at par), that is convertible into ten shares of the issuer's stock, with a conversion value of $800 (e.g., convertible into ten shares, spot rate $80). The annual interest rate is 2.0%. With the issuance of the debt instrument and to hedge the risk thereunder, XYZ purchased an American-style call option pursuant to which it has the right to receive a payment in cash or stock equal to the excess of the price of the stock over the option's exercise price, which is equal to the debt's conversion price. The option premium equals 30% of the debt's proceeds. The resulting synthetic debt instrument will be treated as issued with original issue discount ("OID") equal to the amount of the purchased call premium (i.e., 30%, or $300 discount). Consequently, XYZ will be able to deduct the cash coupon plus the OID throughout the term of the debt instrument.

G. Consolidated Return Hedging

The consolidated hedging rules allow consolidated tax return group taxpayers flexibility to adopt tax hedging rules that best fit the hedging procedures used by the group. The general rule is that group members are treated as divisions of a single corporation for the hedging rules (the "single-entity" approach).[85] This approach would be compatible with a group in which one member hedges the risk of all members by entering into hedging transactions with counterparties outside the group. Applying this approach to

85. Reg. § 1.1221–2(e)(1).

such a group, the hedge position would, by definition, not be separated from the risk being hedged and, accordingly, the hedge would satisfy the requirement that the transaction manage risk of the taxpayer that enters into the transaction. Absent this approach, hedge positions not entered into by the legal entity that has the risk are not eligible for tax hedge status.

If the single-entity approach is adopted, inter-member transactions that act to shift risk to another member for eventual hedging outside the group will not be recognized as tax hedging transactions because they will not manage the risk of the group.[86] These intra-group transactions will, however, be subject to the intercompany transaction rules for consolidated returns.[87] Under these rules, any gain or loss recognized by the hedging member from an intra-group transaction would be offset by a loss or gain required to be recognized by the other member-counterparty. The single-entity rules may create a timing mismatch between the inter-member hedge and the hedged item within that entity if the hedge is marked to market and the hedged item is accounted for on a realization method.

Alternatively, the rules allow for an elective "separate-entity" approach to be used by a consolidated group.[88] This approach will result in each member being treated as a separate corporation with respect to the tax hedging rules. Under the separate-entity approach, an inter-member transaction can be a hedging transaction only if it otherwise would qualify as a hedging transaction and the related counterparty to the hedge marks the position to market under its tax method of accounting.[89]

If the single-entity approach is adopted, the hedging transaction and the risk being hedged still must be identified. These identifications can be made by using either of two procedures. If intra-group transactions are used to transfer risk, the hedging member may identify (on the day the transaction is entered into) the hedging transaction with the outside counterparty as a tax hedge and appropriately identify its position in the intra-group transaction as the risk being hedged. The member having the risk may then timely identify its position in the intra-group transaction as a tax hedge and appropriately identify the risk being hedged within the required time period.

Alternatively, the group member that enters into the hedging transaction with the outside counterparty can timely identify the hedge as a tax hedge and appropriately identify the risk being hedged (even if the risk resides in another member of the group) within the required time period.[90] If the separate-entity approach is adopted, each member of the group must satisfy the identification requirements as though it were not a member of the group.[91]

86. Reg. § 1.1221–2(e)(1).
87. Reg. § 1.1221–2(e)(4), Ex. 1(i).
88. Reg. § 1.1221–2(e)(2).
89. Reg. § 1.1221–2(e)(2)(ii).
90. Reg. § 1.1221–2(f)(5)(i).
91. Reg. § 1.1221–2(f)(5)(ii).

III. STRADDLES (SECTION 1092)

A. General

A good economic hedging transaction with the purpose of managing risk that nevertheless fails to satisfy the tax hedging rules (either substantively, e.g., as being a hedge of a capital asset, or for failure to properly and timely identify it) would most likely result in the long and short positions being treated as a tax straddle, the consequences of which are generally not favorable to the taxpayer.

Congress adopted the straddle rules of section 1092 in 1981 in response to certain abusive transaction (one of which, the so called "butterfly," is described below). Congress was concerned that the then existing anti-abuse rules (such as the wash sale and short sale rules) were inadequate to prevent abuse.[92] Specifically, as the Joint Committee's Report accompanying the 1981 legislation indicates, Congress was concerned that investment professionals and taxpayers had become more aggressive in designing transactions that would not be subject to the existing tax rules and would allow taxpayers to defer income recognition and accelerate losses.[93]

In general terms, section 1092 prevents taxpayers that enter into in a "straddle" (such as the one described below as the "butterfly") from selectively recognizing gains and losses. In other words, in the absence of section 1092, a taxpayer with offsetting positions could recognize the tax loss on one position in the current tax year, while simultaneously deferring tax recognition of the gain in the offsetting position until a later taxable year. Thus, under section 1092, among other consequences, the loss is deferred to the extent of the unrealized gain in the offsetting position of the straddle.

> *Example: The Butterfly.* On November 1, 2014, the taxpayer enters into the following futures contracts: (1) one long February 2015 futures contract on gold, (2) two short June 2015 futures contracts on gold, and (3) one long October 2015 futures contract on gold. On December 20, 2014, gold has risen in value. The taxpayer closes out

---

92. *See* STAFF OF THE JOINT COMM. ON TAX'N, 97TH CONG., JCS-71-81, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 282–83 (Joint Comm. Print 1981) [hereinafter JCT 1981 BLUEBOOK] ("The [1981] Act provides rules to prevent deferral of income and conversion of ordinary income and short-term capital gain into long-term capital gain on straddle transactions.").

93. *Id.* at 283 (connecting a "marked increase in the number of demands for delivery on Treasury bill futures contracts" to an increase "to tax-motivated [straddle] transactions").

> the two short June 2015 contracts and recognizes a loss. The taxpayer enters into a short April 2015 futures contract and a short August 2015 contract. The taxpayer uses the loss to offset unrelated gain and defers recognition of gain on the appreciated contracts.

As I argue in this article, while the straddle rules were enacted to prevent abusive situations where taxpayers use offsetting positions to accelerate losses while deferring the gain on the offsetting position, this does not mean that any situation of offsetting positions must result in a straddle. If a taxpayer enters into offsetting positions with the purpose of managing risk, the straddle rules should not apply.

B. Scope and Definitions

Similar to the wash sale rules of section 1091 (and later rules such as "constructive sales" under section 1259), the straddle rules constitute a departure from the general realization principle inherent in the U.S. federal income tax system. A "straddle" is defined as an offsetting position in "actively traded personal property."[94] For this purpose, "personal property" is any personal property of a type which is actively traded.[95] Property is "actively traded" if there is an established financial market for the personal property (e.g., a national securities exchange, interdealer quotations system, or interbank market). A taxpayer holds an "offsetting position" if there is a substantial diminution of a taxpayer's risk of loss from holding any position with respect to personal property by reason of holding one or more positions with respect to personal property—the contra (or offsetting) position.[96]

> *Example: Long Position and a Put.* A taxpayer buys Google stock at $400. When Google stock is trading at $625, the taxpayer buys a put option with a strike price of $600 to limit his downside risk. The premium paid for the put option is $50. At a time when Google stock is trading at $610, the put option expires unexercised. If the stock is held by the taxpayer as a capital asset, the transaction does not qualify as a hedging transaction and, therefore, would be a straddle. As a result, any loss on the put option is deferred because it is less than the unrecognized gain ($210) even though Google stock declined in value during the straddle period.

---

94. I.R.C. § 1092(c)(1).
95. I.R.C. § 1092(d)(1).
96. I.R.C. § 1092(c)(2)(A).

C. *Consequences of a Straddle*

Section 1092(a) provides that losses on one or more positions in a straddle may not be allowed to the extent of the taxpayer's "unrecognized gain" in the offsetting position, and the disallowed loss is carried forward to the succeeding tax year.[97] For this purpose, "unrecognized gain" is defined in section 1092(a)(3) as "the amount of gain which would be taken into account with respect to such position if such position were sold on the last business day of such taxable year at its fair market value."

Another consequences of a straddle involves holding period. Pursuant to Regulations section 1.1092(b)–2T, if the taxpayer has held a position for less than a year and enters into an offsetting position, the existing holding period is forfeited. When the taxpayer closes out the offsetting position and continues to hold the original position, its holding period starts again at zero. Importantly, this is not a "suspension" of the holding period—it completely eliminates any previous holding period the taxpayer had in the position. If the taxpayer has held the position for more than a year and enters into an offsetting position that the taxpayer then disposes of at a loss, the loss is a long-term capital loss.

Section 263(g), another statutory anti-abuse provision that is strongly related to section 1092, was also enacted in 1981. Section 263(g) was enacted in response to "cash and carry" transactions.[98]

> *Example: Cash and Carry Transactions.* To illustrate using an example adapted from the legislative history of section 263(g),[99] a taxpayer borrowed on January 1, 1981, $100,000 for 24 months and used the proceeds to buy 1,000 ounces of gold at $100 an ounce. Simultaneously, the taxpayer entered into a forward contract to sell 1,000 ounces of gold in two years at a price of $120 per ounce. The long and short positions in the gold would be a straddle. The yield to maturity on the loan was 10%, payable only at maturity (i.e., zero coupon debt), and the other costs associated with holding the long position in the gold for 24 months were $2 per ounce, which were payable at the end of the second year. Thus, at the end of the two-year period, the taxpayer would owe $121,000 on the loan and $2,000 of other costs (for a total of $123,000 liability), but would receive $120,000 on the forward contract. As a result, in the absence of a tax benefit, the overall result for the taxpayer from the loan, long position

97. According to I.R.C. § 1092(d)(2), "[t]he term 'position' means an interest (including a futures or forward contract or option) in personal property."

98. *See* JCT 1981 BLUEBOOK, *supra* note 92, at 292–93.

99. *See id.*

> in the gold (plus associated costs), and the forward contract would be a net loss of $3,000.
>
> Prior to the enactment of section 263(g), however, the taxpayer could deduct the 10% of interest over the life of the loan as it accrued while it would realize a long-term capital gain of $20,000 on the sale of the gold pursuant to the forward contract but only upon the maturity of the forward contract in January 1, 2011. Thus, because the interest was deductible currently while the gain on the forward was deferred, the taxpayer would actually make an after tax profit. Furthermore, the gain on the forward contract would be long term capital gains subject to lower tax rates, while the interest deduction would be ordinary, which could be used to offset the taxpayer's other sources of ordinary income.

Congress responded to this potential abuse by enacting section 263(g) (and indicated specifically that the enactment of section 263(g) was in response to such transactions). Pursuant to the section, interest and carrying charges allocable to personal property that is held as an offsetting position of a straddle must be capitalized. Thus, as a threshold matter, section 263(g) is only triggered if a straddle exists. Similar to the test under section 265 (leveraged tax-exempt bonds), the crucial question is whether a debt was "incurred or continued to purchase or carry" a position in a straddle.[100]

D. *Identified Straddles*

The identified straddle rules are considered the best alternative for hedging of capital assets to avoid the harsh straddle rules. Presumably, anyone who "identifies" a straddle in preparation for an audit is confident that the straddle is not entered into for tax abusive purposes. If a taxpayer identifies a straddle as an "identified straddle," pursuant to section 1092(a)(2)(A), the general loss disallowance rule described above does not apply. Instead, the basis of the retained position(s) in the straddle is increased by the amount of the recognized loss on the offsetting position. At this point, the loss is allocated based on the relative straddle period of the gain in the offsetting position. The taxpayer gets the benefit of the loss as the offsetting positions are sold.

To utilize the identified straddle provision for this purpose, a taxpayer first must identify a hedging transaction as an identified straddle before the close of the day the position in the straddle is acquired. However, pursuant to section 1092(a)(2)(B) an "identified straddle" (1) must be identified by the taxpayer as an identified straddle; (2) on the day the straddle was entered into;

---

100. *See also* I.R.C. § 1277 (debt incurred or continued to purchase or carry a market discount bond); I.R.C. § 1282 (debt incurred or continued to purchase or carry a short-term obligation; using test identical to the one I.R.C. § 1277).

(3) neither position has an inherent loss at the time the straddle is entered into; and (4) the straddle is not part of a larger straddle.

As enacted in 1981, however, the original identified straddle revision was very limited in scope and impractical because it applied only where all the positions of the straddle were acquired on the same day and disposed of on the same day. In 2004, in response to criticism that the provision was overly narrow, the identified straddle rules were significantly expanded to allow identification of *any* straddle as long as such an identification was made before the close of the day on which the straddle was created.[101]

The 2004 legislation also adopted a different rule for recognition of losses in the case of an identified straddle.

> [I]f there is any loss with respect to any identified position of the identified straddle, the basis of each of the identified offsetting positions in the identified straddle shall be increased by an amount which bears the same ratio to the loss as the unrecognized gain with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all such offsetting positions.[102]

> *Example: Identified Straddle.* B holds 1,000 shares of GE stock, with a basis of $30 per share and fair market value of $35 per share. B buys put options on 900 shares with a strike price of $32 per share. B pays a premium of $2,700 for the put options. Assume that GE stock goes up to $40/share and the put options expire worthless. If B identified the put options as offsetting 900 specified shares, and section 1092(a)(2) applies, B's basis in each of the 900 shares will be increased by $3 to $33/share. If B then sells 500 of those shares, B's gain will be $3,500 (500 x $7) rather than $5,000. B will have obtained the benefit of 5/9 of the loss on the put options. In contrast, under the loss deferral rule of section 1092(a)(1), B would not get the benefit of any of the loss if GE remained at $40 at yearend.

In conclusion, as discussed in greater detail herein, the identified straddle rules should be considered as the preferred model for expanding the hedging rules to hedging of capital assets.

---

101. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 888, 118 Stat. 1418, 1642.

102. *Id.*

E. Qualified Covered Calls

The general straddle rules also do not apply when a taxpayer holds stock and writes a "qualified covered call option" ("QCC") on the stock. Section 1092(c)(4) requires that the option be traded on an exchange. Regulations have extended this rule to include over-the-counter ("OTC") options. However, the option cannot be "deep-in-the-money" (as defined in section 1092(c)(4)) and must be granted more than 30 days before the expiration date. Regulations issued in 2002 adjust deep-in-the-money benchmarks for options with terms greater than one year and deny QCC status for options with terms greater than 33 months.

IV. MARK-TO-MARKET

The mark-to-market principle currently is applicable under U.S. federal income tax law only in limited circumstances. In particular, as of now, mark to market only applies to securities that are subject to section 475 and certain instruments subject to section 1256. Both of these regimes do not apply to hedging transactions. As of now, hedging transactions are marked to market only in very limited circumstances (such as where the hedged item is marked to market under either of these provisions).

A. Section 1256

Section 1256 was enacted as part of the Economic Recovery Tax Act of 1981.[103] The legislative history of section 1256 indicates that the provision was enacted to overcome the tax sheltering impact of certain commodity futures trading strategies and to harmonize the tax treatment of commodities futures contracts with the realities of the marketplace under what Congress referred to as the doctrine of constructive receipt.[104]

By 1981, commodity futures straddles (and other types of straddles) were increasingly being used to defer income and capital gains into succeeding tax years, as well as to convert short-term gains into long-term gains, ordinary income into capital gains, and capital losses into ordinary deductions. Price fluctuations in the commodity resulted in one of the contracts showing a loss and the other showing a gain of generally equivalent magnitude. The loss position would be closed out in the year of purchase, but would immediately be replaced (switched) in order to protect the gain in the offsetting position

---

103. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 503, 95 Stat. 172, 327–30 (1981).

104. S. REP. NO. 97-144, at 155–57 (1981).

from being recognized. The loss realized from the closed position could be used to offset an unrelated gain of the taxpayer.[105] The transaction could be repeated indefinitely, thereby avoiding the tax liability associated with the original gain.[106]

As the Senate Finance Committee Report explains:

> The committee bill adopts a mark-to-market system for the taxation of commodity futures contracts. This rule applies the doctrine of constructive receipt to gains in a futures trading account at year-end. The application of this rule in present law means, for example, that taxpayers must include in their income any interest which has accrued during the year, even though they may not have withdrawn the interest from their savings accounts. Because a taxpayer who trades futures contracts receives profits as a matter of right or must pay losses in cash daily, the committee believes it appropriate to measure the taxpayer's futures' income on the same basis for tax purposes.[107]

Section 1256 was revolutionary because it was the first time that the Code applied mark-to-market treatment to financial instruments. Marking the value of an instrument to market means that taxpayers pay taxes (or get deductions) for unrealized gains or losses (also known as "taxation without realization").

Section 1256(a) provides for the basic tax consequences applicable to the acquisition and holding of a position which qualifies as a "section 1256 contract." Section 1256(b)(1) defines the term "section 1256 contract" to include any "regulated futures contract" ("RFC").[108] An RFC is defined in section 1256(g)(1) as a "contract (A) with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and (B) which is traded on or subject to the rules of a qualified board or exchange."[109]

---

105. *Id*. at 156. When both positions were closed the following year, the taxpayer usually had a net gain roughly equivalent to the loss that was realized in the previous year.

106. *Id.*

107. *Id*. at 157.

108. I.R.C. § 1256(b)(1)(A).

109. A "qualified board or exchange" includes a domestic board of trade designated as a contract market by the CFTC, or any other exchange, board of trade, or other market which the Secretary determines has rules adequate to carry out the purposes of this section. I.R.C. § 1256(g)(7)(B)–(C).

Section 1256 contracts also include any foreign currency contract, any non-equity option, and any dealer equity option.[110] Importantly, section 1256(e) contains an exception from the mark-to market requirement for hedging transactions, with reference to the definition in section 1221(b)(2)(A).

Pursuant to section 1256(a), each section 1256 contract held by a taxpayer at the close of the taxable year is marked to market on the last business day of each taxable year, and any gain or loss is then taken into account.[111] Thus, any contract qualifying as a "section 1256 contract" held by the taxpayer at the end of the taxable year is deemed sold at its fair market value on the last business day of such taxable year even though the taxpayer may continue to hold the position, and the taxpayer is required to recognize gain or loss on the deemed disposition regardless of the taxpayer's actual holding period.

The legislative history of section 1256 explained that one of the reasons for the enactment of the mark-to-market principle was to follow GAAP principles pertaining to futures contracts.[112] When section 1256 was enacted, futures transactions were marked-to-market for financial accounting purposes.[113]

Pursuant to the Technical Corrections Act of 1982 and the Deficit Reduction Act of 1984 ("DEFRA"), Congress expanded the applicability of section 1256 to certain foreign currency contracts and options.[114] Most

---

110. I.R.C. § 1256(b)(1)(B)–(E).

111. I.R.C. § 1256(a)(1) ("[Instruments] . . .*shall be treated as sold for its fair market value on the last business day of such taxable year*. . . .") (emphasis added). Of the gain or loss realized by the taxpayer with respect to a "section 1256 contract," 40% is treated as short-term capital gain or loss, and 60% is treated as long-term capital gain or loss. *See* I.R.C. § 1256(a)(3)(A)–(B).

112. S. REP. NO. 97-144, at 156–57 (1981).

113. Although *Accounting for Futures Contracts Statement of Financial Accounting Standards No. 80* was issued by the Financial Accounting Standards Board in 1984, accountants had been marking futures to market prior to 1981. *See Summary of Statement No. 80*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/summary/stsum80.shtml (last visited Dec. 10, 2016).

114. The legislative history indicates that Congress felt that foreign currency contracts were economically similar to RFCs, used interchangeably with RFCs by traders, and therefore should be subject to the same tax treatment. In effect, the expansion was designed to prevent taxpayers from avoiding mark-to-market treatment by purchasing forward contracts, rather than RFCs. Although foreign currency contracts are not subject to daily cash margin settlement or a mark-to-market system, Congress apparently felt that the expansion of section 1256 treatment to the interbank market for currency futures was appropriate under the auspices of treating similar transactions in different markets similarly. *See* H.R. REP. NO. 97-986, at 24–27 (1982) (Conf. Rep.); SEN. REP. NO. 97-592, at 25–28 (1982); H.R. REP. NO. 97-794, at 22–24 (1982). In a similar manner, the DEFRA legislative history explains the expansion of section 1256 treatment to nonequity and dealer equity options without a policy

importantly, in contrast to the original instruments that were subject to section 1256 (i.e., futures), the newly added instruments were not marked to market for financial accounting purposes before 1998, and parties to such instruments could not have access to their daily gains.[115]

B. Section 475: Mark-to-Market for Dealers and Electing Traders in Securities

The objective of the mark-to-market method under section 475 is achieving "clear reflection of income" within the meaning of section 446.[116] In advocating book-tax conformity**,** Treasury noted in 1992 that the mark-to-market method used by securities dealers "represents the best accounting practice in the trade or business of dealing in securities and is the method that most clearly reflects the income of a securities dealer."[117] The legislative and executive branches also indicated that section 475 would move the U.S. federal income tax rules pertaining to dealers in securities closer to the already accepted accounting treatment principles.[118]

---

discussion of the appropriateness of taxing income from such products before realization. The discussion centers, rather, on uncertainties arising from the enactment of the previous mark-to-market rules under section 1256. Doubt concerning the application of those rules to the tax treatment of other products created ambiguity in which taxpayers could whipsaw the government as to the proper tax treatment. At the same time, Congress was concerned about the disparity of treatment of options market makers on securities exchanges and professional traders on commodity exchanges. *See* H.R. REP. NO. 98-861, at 898–917 (1984) (Conf. Rep.); S. REP. NO. 98-169, at 284–97 (1984); H.R. REP. NO. 98-432, at 1262–71 (1984). *See also* STAFF OF THE JOINT COMM. ON TAX'N, 98TH CONG., JCS-41-84, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 301–24 (Joint Comm. Print 1984).

115. *See Summary of Statement No. 133*, FIN. ACCT. STANDARDS BOARD, http://www.fasb.org/summary/stsum133.shtml (last visited Dec. 10, 2016).

116. *See* STAFF OF THE JOINT COMM. ON TAX'N, JCS-39-85, TAX REFORM PROPOSALS: ACCOUNTING ISSUES 6–7 (Joint Comm. Print 1985) (discussing in general terms the cash and accrual methods of accounting, including their shortcomings).

117. U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE PRESIDENT'S BUDGET PROPOSALS AFFECTING RECEIPTS 89 (1992), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY1993.PDF [hereinafter 1992 TREAS. EXPLANATION].

118. H.R. REP. 103-111, at 661 (1993) ("Inventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement purposes . . . ."); U.S. DEP'T OF THE TREASURY, SUMMARY OF THE ADMINISTRATION'S REVENUE PROPOSALS 46–47 (1993), https://www.treasury.gov/resource-center/tax-

Pursuant to section 475(a), all securities, including derivatives, held by a dealer, are marked-to-market unless they are specifically identified as being excluded from mark-to-market treatment.

Under section 475(b)(1), however, the mark-to-market rules do not apply to securities that are identified by the dealer as being exempt from mark-to-market in the following situations: (1) any security held for investment;[119] (2) any debt instrument acquired or originated by the taxpayer in the ordinary course of its trade or business, which is not held for sale;[120] and (3) any security that is a hedge with respect to either a security not subject to the mark-to-market rules or to any position, right to income, or liability that is not a security in the hands of the taxpayer.[121]

Thus, as emphasized above, hedging transactions will be marked to market only if the hedged item is itself property marked to market under section 475, and in such case, clear reflection of income mandates to mark the hedging transaction to market as well.

For purposes of section 475, pursuant to section 475(c)(1), a "dealer in securities" is a taxpayer who regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.[122] Whether one is a dealer in securities will be determined on the basis of all the facts and circumstances.[123]

The term "security" for this purpose is very broad and includes: (1) a share of stock in a corporation; (2) a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (3) a note, bond, debenture, or other evidence of indebtedness; (4) an interest rate, currency, or equity notional principal contract; (5) evidence of an interest in, or a derivative financial instrument in, any security described above, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency (excluding any contract to which section 1256(a) applies); and (6) a position that (i) is not a security described in (1), (2), (3), (4), or (5), (ii) is a hedge with respect to such a security, and (iii) is clearly identified in the dealer's records as being described in this subparagraph before the close of the day on which it was

---

policy/Documents/General-Explanations-FY1994.PDF; 1992 TREAS. EXPLANATION, *supra* note 117, at 89–90. *See also* Bank One Corp. v. Comm'r, 120 T.C. 174, 280–84, 291–02 (2003) (discussing history and application of I.R.C. § 475).

119. I.R.C. § 475(b)(1)(A).

120. I.R.C. § 475(b)(1)(B).

121. I.R.C. § 475(b)(1)(C).

122. I.R.C. § 475(c)(1).

123. Reg. § 1.475(c)–1(a).

acquired or entered into (or such other time as the Treasury may prescribe by regulations).[124]

Certain items are excluded from the definition of a security for purposes of section 475.[125] Most notably, the term security does not include the taxpayer's liabilities, the taxpayer's stock, and debt instruments issued by the taxpayer.

A "trader" in securities or a dealer or a trader in commodities may elect to be governed by section 475.[126] If a trader in securities makes an election under section 475(f), it follows most of the mark-to-market rules of section 475. The rules of section 475 apply to commodities held by an electing commodities dealer in the same manner as they apply to securities held by a securities dealer.[127]

C. Summary

Under both sections 475 and 1256, a hedging transaction is excluded from mark-to-market treatment. The only circumstances that would result in marking a hedging transaction to market is where the hedged item itself is marked to market. In such cases, pursuant to the clear reflection of income principle of section 446, when the hedged item is marked to market, the hedging transaction should be marked to market as well. The Camp proposal discussed immediately below would expand the scope of derivatives that are marked to market, the result of which would be that more hedged items will be marked to market (and thus, more hedging transactions will be marked to market).

Nevertheless, the treatment of the hedging transaction would still depend on the hedged item; even under the Camp proposal, hedging transactions will be excluded from mark to market unless the hedged item is marked to market. In contrast, for GAAP purposes, as discussed below,

---

124. I.R.C. § 475(c)(2).

125. Those items include: (1) a security if I.R.C. § 1032 prevents the taxpayer from recognizing gain or loss with respect to that security (includes stock of the taxpayer and any options on the stock—e.g., a mutual fund would not be treated as a dealer in securities because it sells and redeems its own shares); (2) liabilities of the taxpayer; (3) a REMIC residual interest acquired on or after January 4, 1995, and negative value REMIC residuals acquired before January 4, 1995; (4) synthetic debt that is treated as integrated debt under Reg. §1.1275–6; and (5) non-financial customer paper as defined in I.R.C. § 475(c)(4). Reg. § 1.475(c)–2(a).

126. I.R.C. § 475(e)–(f). Note that the application of section 475 to physical commodities creates a book-tax difference because commodities are not marked-to-market for GAAP purposes.

127. I.R.C. § 475(e)(1).

hedging transactions are marked to market *per se*, regardless of whether the hedged item is marked to market or not.[128]

V. THE WAYS AND MEANS COMMITTEE'S PROPOSED REFORM FOR DERIVATIVES

A. *Overview*

On January 24, 2013, David Camp, Chairman of House Ways and Means Committee released a Tax Reform Proposal on Financial Instruments (the Camp Draft), which would provide uniform tax treatment of derivatives and simplify business hedging tax rules.[129] Two parts of this proposed reform are discussed herein as relevant to the discussion on hedging transactions.

Specifically, the proposed mark-to-market treatment for derivatives would significantly change the current landscape with respect to taxation of derivatives. Second, the proposed consolidation of book and tax hedge identification would simplify procedural matters applicable to hedging. While this revolutionary proposal has yet to move forward in Congress, it clearly indicates that the U.S. federal income tax system most likely is expected to adopt more mark-to-market principles in the near future.

B. *Mark-to-Market Treatment for Derivatives*

1. *General*

According to the Committee, "[b]roadly extending mark-to-market accounting treatment to derivatives would provide a more accurate and consistent method of taxing these financial products and make them less susceptible to abuse, without affecting most small investors who normally do not invest in these products."[130]

The Camp Draft would require only taxpayers that are engaged in speculative financial activity (as opposed to hedging) to mark certain

128. *See infra* Part VI.C.

129. Press Release, House Ways & Means Committee, Camp Releases Financial Products Tax Reform Discussion Draft to Hold Wall Street Accountable and Protect Taxpayers by Creating a Simpler, Fairer Tax Code (Jan. 24, 2014), https://waysandmeans.house.gov/camp-releases-financial-products-tax-reform-discussion-draft-to-hold-wall-street-accountable-and-protect-taxpayers-by-creating-a-simpler-fairer-tax-code/.

130. Overview of Ways and Means Tax Reform Discussion Draft: Financial Products 2, http://waysandmeans.house.gov/UploadedFiles/Overview_of_WM_Discussion_Draft_Financial_Products.pdf (last visited Dec. 10, 2016) [hereinafter Camp Draft Overview].

derivative positions to market.[131] Thus, if this proposal is adopted, hedging transactions (as well as hedged items) will still not be marked to market.

2. *Overview of the Proposed Mark-to-Market Rules*

Gain or loss from derivatives would generally be recognized under a mark-to-market rule, and such gains or losses would be ordinary.[132] Thus, derivatives that are currently subject to section 1256 would now be taxed simply as ordinary.[133] In addition, the gains and losses would be treated as attributable to a trade or business of the taxpayer.[134] Mark-to-market and ordinary treatment would also apply to the termination or transfer of a taxpayer's rights or obligations with respect to a derivative (broadly defined to include offsetting; taking or making delivery; exercise or being exercised; assignment or being assigned; lapse, expiration, settlement, or otherwise).[135]

3. *Fair Market Value*

A determination of fair market value has always been a big obstacle for broader adoption of a mark-to-market regime in the United States.[136]

---

131. *Id.* ("Derivatives that are used by businesses in the ordinary course of their businesses to hedge against price, currency, interest rate, and other risks would *not* be affected.").

132. Under proposed I.R.C. § 485, all mark-to-market gains and losses from derivatives would be ordinary. Ways and Means Discussion Draft, 113th Cong. § 401 (2013), https://waysandmeans.house.gov/UploadedFiles/Leg_text_fin.pdf [hereinafter Ways & Means Discussion Draft].

133. The Camp Draft would create new Code sections 485–486 for taxation of derivatives and repeal Code sections 1256, 1234B and 1236. Ways & Means Discussion Draft, *supra* note 132, at § 401; *see also* Tax Reform Act of 2014, H.R. 1, 113th Cong. § 3401 (2014) [hereinafter 2014 Reform Act]; STAFF OF THE JOINT COMM. ON TAX'N, 113TH CONG., JCS-1-14, TECHNICAL EXPLANATION, ESTIMATED REVENUE EFFECTS, DISTRIBUTIONAL ANALYSIS, AND MACROECONOMIC ANALYSIS OF THE TAX REFORM ACT OF 2014, A DISCUSSION DRAFT OF THE CHAIRMAN OF THE HOUSE COMMITTEE ON WAYS AND MEANS TO REFORM THE INTERNAL REVENUE CODE 281–93 (Joint Comm. Print 2014) [hereinafter JCT, CAMP EXPLANATION].

134. Ways & Means Discussion Draft, *supra* note 132, at § 401(a) (Prop. I.R.C. § 485(b)(2)).

135. *Id.* (Prop. I.R.C. § 485(d)(1)).

136. Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 559 (1991) ("Under an appreciation-based system of taxation, taxpayers and the Commissioner would have to undertake the 'cumbersome, abrasive, and unpredictable administrative task' of valuing assets on an annual basis to determine whether the assets had appreciated or depreciated in value.").

Adoption of the proposed mark-to-market rule obviously would require fair market value determinations for the taxpayer's derivative positions. If the value is not readily ascertainable, it would be determined under the method used by the taxpayer in reports to shareholders, partners, other proprietors, beneficiaries, or as used for purposes of obtaining credit.[137]

4. Definition of Derivative

A "derivative" would be broadly defined under the Camp Draft's proposed section 486 as (1) any evidence of an interest in, or any derivative instrument with respect to, any (a) share of stock in a corporation, (b) partnership interest or beneficial ownership interest in a partnership interest or trust, (c) note, bond, debenture, or other evidence of indebtedness, (d) certain real property, (e) actively traded commodity, or (f) currency; (2) any notional principal contract (NPC); and (3) any derivative instrument with respect to any interest or instrument described above.[138] The definition is intended to be broad in several aspects. It would include options, forwards, or futures with respect to any stock, partnership interest, or debt regardless of whether the contract or interest (or the underlying contract or interest) is privately held or publicly traded.[139] It also includes short sales and short securities futures contracts.[140]

5. Embedded Derivatives

A revolutionary proposal involves embedded derivatives. A derivative would also include any embedded derivative component of a debt instrument (other than certain foreign currency denominated debt instruments, contingent payment debt instrument, VRDIs and debt instruments subject to alternative payment schedule rules).[141] An *embedded derivative* means any term of a debt instrument that affect some or all of the cash flows or the value of other payments on the instrument in a manner similar to a derivative.[142] Thus, the Camp Draft would treat convertible debt as two instruments: non-convertible

---

137. Ways & Means Discussion Draft, *supra* note 132, at § 401(a) (Prop. I.R.C. § 485(e)(1)). Fair market value would be determined without regard to any premium or discount related to the relative size of the taxpayer's position to the total available trading units of an instrument. *Id.* (Prop. I.R.C. § 485(e)(4)).

138. *Id.* (Prop. I.R.C. § 486(a)(1)).

139. *Id.* (Prop. I.R.C. § 486(a)–(b)); *see also* 2014 Reform Act, *supra* note 133, at § 3401 (Prop. I.R.C. § 486(a)).

140. Ways & Means Discussion Draft, *supra* note 132, at § 401(a) (Prop. I.R.C. § 486(b)).

141. *Id.* (Prop. I.R.C. § 486(d)(1)).

142. *Id.* (Prop. I.R.C. § 486(d)(2)).

debt (not subject to the mark-to-market rule) and an option to acquire stock of the issuer (subject to mark-to-market).

C. Proposed Consolidation of Tax and GAAP Hedging Identification Rules

Under the Camp Draft's proposed section 1221(c), a hedging transaction would be treated as meeting the requirements of section 1221 (as a tax hedging transaction) if it is identified as a hedging transaction for tax purposes, or if the transaction is treated as a hedging transaction within the meaning of GAAP for purposes of the taxpayer's audited financial statement.[143] The financial statement must be certified as being prepared in accordance with GAAP by an independent auditor and must be used for the purposes of a statement or report to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes.[144]

A transaction treated as a hedging transaction for GAAP purposes would be treated as a hedging transaction for tax purposes if it met the substantive definition of a tax hedging transaction, which is unchanged by the Camp Draft.[145] According to the Committee, "[t]his taxpayer-favorable proposal would minimize inadvertent failures to identify a transaction as a hedge for tax purposes, even though the transaction satisfies all of the substantive requirements for hedging transaction tax treatment."[146]

VI. The Problems with the Current Tax Hedging Rules

A. Limited Scope

The current U.S. federal income tax hedging rules are limited in their scope in several aspects. First, as a threshold matter, pursuant to sections 1221(a)(7) and 1221(b)(2), the current tax hedging rules are only applicable to ordinary assets and certain liabilities and are limited to transactions entered into in the course of the taxpayer's trade or business. Typically, hedging of ordinary assets (such as inventory) and liabilities would be considered

143. *Id.* at § 402(a) (Prop. I.R.C. § 1221(c)); *see also* JCT, Camp Explanation, *supra* note 133, at 294–97.

144. Ways & Means Discussion Draft, *supra* note 132, at § 402(a) (Prop. I.R.C. § 1221(c)(3)(B)).

145. *Compare* I.R.C. 1221(b)(2)(A) (current definition of "hedging transaction"), *with* Ways & Means Discussion Draft, *supra* note 132, at § 402(a) (Prop. I.R.C. § 1221(c)(1)–(2)) (definition of "hedging transaction" that is identical to current Code).

146. Camp Draft Overview, *supra* note 130, at 2.

transactions entered into in the course of a taxpayer's trade or business (usually referred to as "businesses hedges").

In contrast, hedging transactions of capital assets and/or hedging transactions not entered into in connection with the taxpayer's trade or business (also known as "investment hedges") are not considered "hedging transactions" under the statute and regulations. Because investment hedges are largely excluded from the tax hedging rules, such hedges are not eligible for matching of timing and character and are also exposed to the risk of being treated as straddles, the harsh consequences of which are discussed above.[147]

Congress indicated in both the straddle and hedging provisions that it is willing to accommodate investment hedges. As set forth above, the expansion of the identified straddle rules in 2004 signaled that investment hedges can be excluded from the harsh consequences of a straddle.[148] In addition, section 1221(b)(2)(B) indicates that some hedging transaction that substantively or technically do not satisfy the hedging rules may still be eligible for the matching principle. Using these two provisions as a model, I propose to expand the scope of the tax hedging rules to include hedging of capital asserts.

Second, the current U.S. tax hedging rules are limited in terms of the applicable risks that can be hedged in order to be eligible for hedging treatment. As of now, the hedging transaction may only manage the risk of interest rate changes, price changes, or foreign currency exchange rate fluctuations with respect to borrowings made or to be made or "ordinary obligations" incurred or to be incurred by the taxpayer.[149] There is also a limited rule for an "aggregate" risk.[150] Nevertheless many valid hedgeable risks are not specifically covered under the current rules (for example, gap hedges, discussed in the next subsection).

In addition, Regulations section 1.1221–2(d)(5) specifically excludes from the definition of a "hedging transaction" the purchase or sale of a debt instrument, an equity security, or an annuity contract, even if the transaction limits or reduces the taxpayer's risk (or in other words, manages the taxpayer's risk) with respect to ordinary property, borrowings, or ordinary obligations.

There is no reason to limit the types of risks that can be managed to be eligible for hedging treatment. As I propose herein, Regulations section 1.1221–2(d)(5) should be repealed, and Treasury should use the mandate

147. *See supra* Part III.

148. *See supra* note 101 and accompanying text.

149. Reg. § 1.1221–2(b), (c)(2); *see supra* notes 25–26 and accompanying text.

150. Reg. § 1.1221–2(c)(3); *see supra* note 27 and accompanying text.

given by Congress to expand the scope of risks that can be managed[151] (consider, for example, recent guidance accommodating "gap hedging"[152]).

Third, for entities subject to financial accounting reporting, there is no conformity of the tax hedging rules with the financial accounting hedging principles.[153] Such nonconformity exists in three different aspects of hedging transaction. First, the scope of what constitutes a "hedging transaction" for financial accounting and tax purposes significantly differs. In general, the financial accounting hedging rules cover a wider scope of transactions than those covered for tax law purposes. Second, the financial accounting timing principles for the hedging transaction (and hedged items) differ from the tax timing rules (which are mandated by the vague standard of Regulations section 1.446–4). Finally, identifying a hedging transaction for tax purposes requires separate identification from the financial accounting identification.

I propose below a comprehensive book-tax conformity for hedging transactions, pursuant to which companies subject to GAAP will conform their book and tax hedging treatment in terms of scope, timing rules, and identification.

In conclusion, many true economic hedges that would be classified as hedging transactions for financial accounting purposes often fall out of the scope of the tax hedging rules, creating not only book-tax difference but also, timing, character, and even amount mismatches. Even worse, a true economic hedge that is left out of the scope of a hedging transaction under current law most likely will result in a straddle, the bad consequences of which are discussed above.[154]

B. Gap Hedges

One particular example of where many true hedgers needed clarification in terms of whether they can qualify for hedging treatment (and where the Service finally clarified this issue) involves "gap hedges." The term "gap hedge" for this purpose involves the hedge of a "gap" between the attributes of a taxpayer's liabilities (e.g., floating rate) and the assets funded by such liabilities (e.g., fixed rate) without specifically identifying the hedged assets or liabilities. This type of hedging transaction is commonly utilized by insurance companies that attempt to lock in a spread between their assets and liabilities.

---

151. I.R.C. § 1221(b)(2)(A)(iii) provided authority for the Treasury to make clear through regulations what other types of risks can qualify for hedging treatment.

152. *See infra* notes 155–159 and accompanying text.

153. *See infra* Part VI.C.

154. *See supra* Part III.

It is often very difficult for the taxpayer to determine whether a gap hedge, in substance, constitutes a hedging transaction with respect to the taxpayer's assets, which are capital assets, or a hedge of the taxpayer's liabilities and/or ordinary obligations. Accordingly, depending on the specific facts and circumstances, taxpayers that conduct gap hedging may be considered to be hedging capital assets rather than hedging the risk with respect to liabilities and/or ordinary obligations. Obviously, this would be disadvantageous for insurance companies using such hedges.

As discussed above, in section 1221(b)(2)(A)(iii), Congress granted authority to Treasury and Service to make clear through regulations what other types of risks can qualify for hedging transaction treatment.[155] In the preamble to the final hedging regulations issued March 20, 2002, the Service and Treasury indicated that the gap hedges of insurance companies were not separately addressed in the final regulations, stating that "[w]hether a gap hedge qualifies as a liability hedge is a question of fact and depends upon whether it is more closely associated with the liabilities than with the assets."[156]

Treasury and Service have yet to expand the regulations to more risk. Nevertheless, recently, the Service's Large Business and International Division (LB&I) issued a Directive that provides a "safe harbor" for certain types of gap hedges (entitled therein as "Guaranteed Minimum Benefit Hedges," or GMB Hedges), which is generally viewed in the industry as applicable to most if not all types of gap hedges.[157] The Directive provides that examiners would not challenge (1) whether certain GMB Hedges qualify for hedging treatment under Regulations section 1.1221–2(b);[158] (2) the mark to market values of eligible GMB Hedges if they conform to the values reported in the company's annual statement; and (3) the method of accounting for income, deductions, gains, and losses relating to eligible GMB Hedges for variable annuity contracts issued before Dec. 31, 2009, if the method meets certain requirements discussed below.[159]

---

155. *See supra* note 151 and accompanying text.

156. T.D. 8985, 2002–1 C.B. 707, 709.

157. I.R.C. §446: LB&I Directive for Hedging of Variable Annuity Guaranteed Minimum Benefits by Insurance Companies, LB&I–04–0514–005 (July 17, 2014), https://www.irs.gov/businesses/irc-446-lbi-directive-related-to-hedging-of-variable-annuity-guaranteed-minimum-benefits-by-insurance-companies [hereinafter LB&I Directive].

158. "GMB Hedge" is as a hedging transaction described in Reg. §1.1221–2(b) that is entered into by an insurance company for the purpose of managing the aggregate risks associated with GMB under variable annuity contracts or transactions that counteract the same; "Eligible GMB Hedge" is a GMB Hedge that satisfies the identification and recordkeeping requirements for hedging transactions contained in Reg. § 1.1221–2(f). LB&I Directive, *supra* note 157.

159. LB&I Directive, *supra* note 157.

Thus, in essence, the LB&I Directive provides a "safe harbor" for insurance companies that enter into such GMB Hedges. While this is a welcome clarification, there is a need for Treasury and Service to use the mandate granted by Congress and expand the types of risk eligible for hedging treatment.

C. Book-Tax Nonconformity

This section discusses the current nonconformity between tax and financial accounting hedging principles.

1. Overview

GAAP rules contain accounting principles applicable to derivatives in general, and hedging transactions in particular, which have the effect of matching the timing of the income recognition of an instrument used as a hedging transaction with that of the hedged item.[160] However, current GAAP and tax rules pertaining to hedging transactions are not in conformity.

Most hedging transactions are marked to market for financial accounting purposes (and mark the hedged items to market as well). In contrast, tax hedging transactions are generally excluded from both sections 475 and 1256, the result of which is that hedging transactions are only marked to market where the hedged items are marked to market as well. Furthermore, as described above, the 2013 Camp proposal would expand the scope of derivatives subject to mark to market, but also would continue the rule that derivatives used for hedging purposes will be excluded from mark-to-market treatment.[161] Thus, in the vast majority of cases, a tax hedging transaction (and hedged item) will create a book-tax difference.

2. General Discussion of Accounting Principles Pertaining to Hedging

For financial accounting purposes, all derivatives must be recorded on the balance sheet at fair value (i.e., marked to market) and there are specific accounting standards for (1) hedges of changes in the fair value of assets, liabilities, or firm commitments (defined as "fair value hedges"), which are recorded at fair value in the balance sheet, with any unrealized gains and losses recorded in net income; (2) hedges of the variable cash flows of forecasted transactions (defined as "cash flow hedges"), which are also recorded at fair value in the balance sheet, but unrealized gains and losses are recorded in

---

160. ACCOUNTING STANDARDS CODIFICATION, Topic 815 (Fin. Acct. Standards Bd.).

161. *Supra* Part V.

equity, as part of other comprehensive income; and (3) hedges of foreign currency exposures of net investments in foreign operations (defined as "foreign currency net investment hedges"), which are special cases of the above two types of hedges.

a. Fair Value Hedges. Generally, fair value hedges protect against changes in value caused by fixed terms, rates, or prices. Corporations must recognize currently in earnings, in the period that a change in value occurs, gains or losses from a derivative designated as a fair value hedge. In addition, changes in the fair value of the hedged item (i.e., the asset, liability, or firm commitment being hedged), to the extent they are attributable to the risk being hedged, are also marked to market, by adjusting the carrying amount of the hedged item and recognizing the changes currently in earnings.

As a result, if the fair value hedge is fully effective, the gain or loss on the hedging instrument would exactly offset the loss or gain on the hedged item attributable to the hedged risk. Any difference that does arise would be the effect of hedge ineffectiveness, which consequently is recognized currently in earnings.

b. Cash Flow Hedges. 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. That exposure may be associated with an existing recognized asset or liability (such as future interest payments on variable-rate debt) or a forecasted transaction (such as a forecasted purchase or sale). Cash flow hedges are also recorded at fair value in the balance sheet, but unrealized gains and losses are recorded in equity, as part of "other comprehensive income," to the extent of the effective portion of the hedge. The ineffective portion is reported in earnings.

c. Foreign Currency Hedges. Generally, an entity may designate the following types of hedges of foreign currency exposure: (1) fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security); (2) 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; and (3) hedge of a net investment in a foreign operation.

The gain or loss on a derivative instrument or non-derivative financial instrument designated and qualifying as a foreign currency hedging instrument is accounted for as follows: (1) gain or loss on a hedge of a foreign-currency-denominated firm commitment and the offsetting loss or gain on the hedged item shall be recognized currently in earnings; (2) gain or loss on a hedge of an available-for-sale security and the offsetting loss or gain on the hedged item shall be recognized currently in earnings; (3) the effective portion of the gain

or loss on a hedge of a forecasted foreign-currency-denominated transaction shall be reported as a component of other comprehensive income and reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings, while the remaining gain or loss on the hedging instrument shall be recognized currently in earnings; and (4) gain or loss on a hedge of a net investment in a foreign operation shall be reported in other comprehensive income (as part of the cumulative translation adjustment to the extent it is effective as a hedge.

d. Definition of a "Derivative." For financial accounting purposes, a hedging instrument generally can only be a derivative that satisfies the following requirements: (1) cash flows or fair value from the instrument must fluctuate and vary based on changes in one or more underlying variables; (2) the instrument must be based on one or more notional amounts and/or payments; (3) the instrument requires no, or insignificant, initial net investment; and (4) the instrument can readily be settled by a net cash payment.

Examples of derivatives that satisfy these requirements include swaps, options, futures, forwards, swaptions, caps, collars and floors. "Regular way" securities trades such as purchases or sales of securities that settle in the normal course for the particular security do not constitute "derivatives."

e. Effectiveness Requirement. For financial accounting purposes, to constitute a qualified hedging transaction, a derivative must be "highly effective" in offsetting exposure to risk due to changes in fair value of cash flows from the hedged item. The accounting hedging principles do not specify how effectiveness should be assessed. Thus, such an assessment should be based on the objective of management's risk management strategy. However, the method of assessing effectiveness must be reasonable and consistent (i.e., the same method be used for similar hedges unless different methods are explicitly justified). The same standard applies to both fair value and cash flow hedges. Thus, as set forth above, to the extent the hedge is effective, the standard for fair value hedges results in offsetting changes in the fair values of cash flows on the hedge and the hedged item.

3. Conclusions

Financial accounting principles pertaining to hedging transaction significantly differ from the current tax rules. Most importantly, most hedging transactions are marked to market for financial accounting purposes, and only limited hedging transactions are marked to market for tax purposes. It is clear, however, that the financial accounting principles are more detailed, coherent,

and usable than the tax rules. Thus, as suggested herein, hedgers that are subject to financial accounting reporting should be allowed to follow their books for tax purposes.

D. Uncertain Timing Rules

As set forth above, the current timing rules pursuant to Regulations section 1.446–4 apply the flexible (but yet vague) "matching" principle, pursuant to which the timing of income, gain, deductions, and loss from the hedging transaction must "reasonably match" the timing of income, gain, deductions, and loss from the hedged items. While this rule allows for some flexibility in terms of choosing the right method to account for the hedging transactions and hedged items, it also creates uncertainty as to the proper timing of recognition of gains/losses from hedges and hedged items.

In particular, while the timing rules are relatively straightforward when both the hedging transaction and the hedged item are entered into and mature (or disposed of) at the same time, the timing rules are uncertain where either the hedge or the hedged item is terminated prior to the other one. This is very typical for hedges of debt instrument, where either the debt or the hedge may be terminated before the other, and the question is how to account for income/deduction from the termination.

As a result, recognition of items of income and deductions on a hedging transaction may be deferred in some cases and may, in other cases, be accelerated, in an attempt to reasonably match the timing of recognition of items of income on the hedged transaction.

For example, on the one hand, recognition of an item of income on a hedging transaction may be deferred pursuant to Regulations section 1.446–4(e)(4), which provides that gain or loss from a hedging transaction in respect of a debt instrument must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. On the other hand, recognition of an item of income on a hedging transaction may be accelerated pursuant to Regulations section 1.446–4(e)(6), where the hedged item is disposed of but the hedging transaction is maintained.

If my proposed book-tax conformity for hedging is adopted, it will at least resolve timing issues for companies subject to financial accounting reporting. Otherwise, the timing rules will have to be reformed and clarified to specify in more details how the rules should apply to given scenarios. In particular, with respect to hedging of debt instruments, I propose to use the integration model (and significantly expand it) to establish a more comprehensive and coherent timing approach for hedging of debt instruments.

E. Swaptions as Example of Uncertain Timing Rules

Swaptions are another example of uncertainty with respect to the timing rules pertaining to hedges of debt instruments. Swaptions are commonly used to hedge anticipatory debt instruments. A swaption is a financial instrument that gives its holder the right to enter into a swap (generally an interest rate swap). Swaptions used as hedging transactions were discussed in an e-mail released June 11, 2010, by the Service's Office of Chief Counsel.[162]

In this Chief Counsel e-mail, European-style swaptions, which expired worthless in the year acquired, were designed to be exercisable at or about the time the taxpayer expected to acquire debt assets. The swaptions were purchased by the taxpayer to hedge future purchases of debt assets, which were ordinary property under section 582(c). The term of the swaps to be issued pursuant to the swaptions would have matched the term of the debt instruments to be issued. The taxpayer was hedging the impact that interest rate changes and the prospected acquired debt instruments would have on its regulatory capital position.

Although the taxpayer timely identified the swaptions as hedging transactions, it did not set forth in its books and records a Regulations section 1.446–4(d)(1) description of how it would account for the swaptions so as to clearly reflect income in accordance with the hedging timing rules.

Citing Regulations section 1.446–3(g)(3) and general option authorities,[163] the taxpayer claimed that it might deduct its loss (the premium paid) on the swaptions upon their expiration. The taxpayer asserted that immediate deduction of the loss would clearly reflect income because the protection it obtained with respect to interest rate movements ended on expiration of the swaptions, suggesting that the gain or loss related to the option term of the swaption and not the underlying swap that would have produced benefits had interest rates moved sufficiently upward in the fashion the hedge sought to protect against.

The Service concluded that the swaption was executed as a hedging transaction and the losses from the swaption that expired worthless must be taken into account over the life of the swap that would have been created had the option been exercised (the term of the underlying swap matched the expected life of the related debt). In reaching this conclusion, the e-mail stated:

> Taxpayer correctly recognizes that premium paid on a swaption is taken into

---

162. C.C.A. 2010–23–055 (Aug. 13, 2009), https://www.irs.gov/pub/irs-wd/1023055.pdf.

163. For example, Revenue Ruling 78–182, 1978-1 C.B. 265.

> account in measuring any gain or loss realized on the lapse or termination of the
> swaption or is taken into account as a nonperiodic payment if and when the underlying swap is entered into. Here, the two swaptions expired worthless, so – just as with straight options–their lapse caused Taxpayer to have realized losses equal to the premium paid for the swaptions. The section 1.446-4 hedge timing rules must then be applied; those rules require that the accounting for the hedge income, deduction, gain or loss be reasonably matched with the income, deduction, gain or loss from the hedged item or items.[164]

Thus, losses from the swaption that expired worthless must be taken into account over the life of the swap that would have been created had the option been exercised.

F. Hedges Versus Straddles

As set forth above, one of the biggest challenges that hedgers face is that many good economic hedges could unintentionally fall into the harsh tax straddle rules.[165] The straddle rules generally do not distinguish between taxpayers entering into offsetting positions with respect to personal property to manage risk with respect such property and speculators that use offsetting positions to take advantage of the tax system.[166] While the identified straddle rules can alleviate some of this burden, they are still limited in their application and not 100% coordinated with both the hedging rules and other straddle rules.

Thus, between the classic business hedgers of business ordinary assets or obligations that satisfy the risk management standard of the tax hedging rule (and identify the hedging transaction and hedged item timely and properly) on the one hand, and the speculators who try to take advantage of the tax system using offsetting positions on the other hand, there are more and more taxpayers (both businesses and individuals) who truly manage risks with respect to capital assets with offsetting positions on such assets, but who are unable to enjoy the matching principle of the tax hedging rules. Not only are such taxpayers very limited in terms of matching the timing and character of the

164 C.C.A. 2010–23–055, at 2 (Aug. 13, 2009), https://www.irs.gov/pub/irs-wd/1023055.pdf (citations omitted).

165. *See supra* Part III.A (explaining how very often, a good economic hedging transaction that does not satisfy the tax hedging rules (either because it does not satisfy the substantive requirement and/or is not properly identified pursuant to the relatively strict tax identification rules) can result in a straddle).

166. *See supra* Part III.A (example illustrating the famous "butterfly" transaction, which was one of the triggers for enacting the straddle statutory provision).

hedging transaction and the hedged item, they could suffer from the harsh consequences of the straddle rules.

> *Example: Hedge of Debt Held as Capital Asset.* Taxpayer (T) owns long-term, fixed-rate debt instruments that it holds as capital assets. T buys a six-month put option on ten-year Treasuries to protect against an increase in interest rates. Since the option is hedging the change in price on a capital asset, the tax hedging rules do not apply.
>
> It is necessary to consider whether a straddle is present. Assuming a straddle is found, and T can identify specific bonds whose principal amount matches the notional principal amount of the option, it can be an "identified straddle." If A identifies the straddle and if interest rates stay flat and the option lapses, T would add its cost of the option to the basis in the bonds. But if interest rates rise, and T has a gain on the option, T must currently recognize the gain even though it has a corresponding unrealized loss on the bonds.
>
> A broader hedging regime that would include hedging of capital assets for true economic hedges would allow T to identify the option as a "capital asset hedge" and would allow for deferral of realized gain on the option until disposition of the bonds. The identified straddle rules could provide a potential model for expansion of the hedging rules to capital assets, but these would have to be coordinated with the hedging rules.

> *Example: Hedges of Debt Instruments Held by a Bank.* Same facts as the previous example except that T is a bank and so holds the bonds as ordinary assets. Assume they are held for investment, so not marked to market. T identifies the option as a hedge. What is the proper treatment under the hedge timing rules?
>
> Possible answers: (1) when the option lapses or is cash settled, spread the resulting gain or loss over ten years, (2) when the option lapses, recognize the loss immediately, but if there is a gain, spread it over ten years, (3) deduct the cost of the option over six months and if the option has cash value when it expires, spread the amount received over ten years, (4) use the identified straddle approach, adjusting basis on actual bonds, giving rise to market discount or premium, or (5) another approach.

G. Tax Hedge Identification Rules Are Too Strict

As set forth above, in order to qualify for tax hedge treatment, the taxpayer must clearly identify the transaction as a hedging transaction before

the close of the day on which the taxpayer acquired, originated, or entered into the transaction.[167] In addition, the taxpayer must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates.[168] Additional information is required for certain types of hedging transactions.[169]

However, the current tax identification rules are too strict and consequently harsh (for failures). It is very easy to miss the deadline for identification, and taxpayers often do miss the deadlines unintentionally. There is very limited flexibility to account for unintended delays or omissions in identification,[170] which means that an unintended delay will result in the taxpayer not only failing the hedging rules but also falling into the straddle rules.

Importantly, the current regulations specify that the identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy the tax identification requirement unless the taxpayer's books and records indicate that the identification also is being made for tax purposes.[171]

To qualify for hedge accounting for financial accounting purposes, an identification must be made at the inception of a hedge, including documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. The documentation must include identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and information for assessing the hedging instrument's effectiveness.

Under the Camp Draft, a tax hedging transaction would be treated as meeting the hedge identification requirement pursuant to section 1221(a)(7) if the transaction is identified as a hedging transaction within the meaning of GAAP for purposes of the taxpayer's audited financial statement.[172] The audited financial statement would have to be certified as being prepared in accordance with GAAP by an independent auditor and must be used for the purposes of a statement or report to shareholders, partners, or other proprietors, or to beneficiaries, or for credit purposes.[173]

---

167. Reg. § 1.1221–2(f)(1); *see supra* Part II.E.

168. Reg. § 1.1221–2(f)(2).

169. Regulations section 1.1221–2(f)(3) details additional requirements for anticipatory asset hedges, inventory hedges, hedges of debt of the taxpayer, hedges of aggregate risk, and transactions that counteract hedging transactions.

170. *See supra* notes 61–62 and accompanying text (discussing the "inadvertent error" exception).

171. Reg. § 1.1221–2(f)(4)(ii).

172. *See* Ways & Means Discussion Draft, *supra* note 132, at § 402(a) (Prop. I.R.C. § 1221(c)(3)(B)).

173. *Id.*

An adoption of this rule would simplify the hedge identification rules for companies subject to GAAP; however, taxpayers who do not prepare audited financial statements under GAAP would not be able to identify hedging transactions based on a financial statement identification. Thus, as I propose herein, it is necessary to set a more flexible exception for inadvertent errors for all hedgers (whether subject to GAAP or not).

VII. Proposed Reform of the Tax Hedging Rules

A. *Conform Book and Tax Hedging Treatment*

As a starting point, I propose that taxpayers that prepare financial statements under GAAP should be allowed to conform their books and tax hedging treatments. For now, I propose an election and not mandating book-tax conformity. If this regime proves to be working, at some point Congress can mandate such conformity.

As set forth above, conforming book and tax treatment of hedging transactions has three aspects: (1) scope of the definition of a "hedging transaction"; (2) timing of income, gain deductions, and loss with respect to the hedging transaction and hedged item; and (3) identification of the hedging transaction and hedged item.[174]

1. *Scope*

For taxpayers that are subject to financial accounting reporting, Congress can codify an elective book-tax conformity (at first) for hedging transactions, generally providing that a transaction that qualifies as a hedging transaction for financial accounting purposes will qualify as a hedging transaction for tax purposes.

As set forth above, financial accounting principles for hedging transaction are very elaborate and provide detailed standards for what transactions should qualify for hedging treatment.[175] Companies subject to financial accounting reporting must conduct a "hedging study" (including a comprehensive "effectiveness test") to determine which transactions would qualify for hedging treatment.

The tax rules, however, are "thinner" and only provide a few specific examples for what would constitute a "hedging transaction" for tax purposes. As discussed above, the tax rules limit the types of assets and risks that will qualify for hedging treatment, and the types of taxpayers (only taxpayers with

174. *See supra* Part II.
175. *See supra* Part VI.C.

a trade or business) that would qualify for hedging treatment.[176] None of these limitations exist in the financial accounting hedging principles.

In my view, the financial accounting standards better reflect what really is a true hedging transaction. Therefore, I suggest that in the case of taxpayers that are subject to financial accounting principles, all transactions that qualify for hedging treatment for financial accounting purposes will qualify as hedging transactions for tax purposes.

To accomplish this change, a new subsection (C) would be added to section 1221(b)(2) and set forth that, notwithstanding the definition of "hedging transaction" in section 1221(b)(2)(A), the term "hedging transaction" includes any transaction that qualifies as a hedging transaction for financial accounting purposes (and the taxpayer treats them as such in its financial statements).

As a result, all transactions that qualify as hedging transactions for financial accounting purposes would automatically qualify as hedging transactions for tax purposes, regardless of the assets or liabilities being hedged and the risk being managed.

2. *Timing*

If a transaction qualifies as a hedging transaction for financial accounting purposes and the taxpayer chooses to treat it as a hedging transaction for tax purposes, the next issue is how the taxpayer should match the timing on the hedging transaction and hedged item. As set forth above, while most hedging transactions are marked to market for financial accounting purposes, for tax purposes hedging transactions are generally out of the scope of sections 475 and 1256 and are only marked to market if the hedged items are marked to market.[177] Even if Congress would have enacted the Camp Draft, which would expand the application of the mark-to-market rules to more derivatives,[178] it would still have excluded hedging transactions from the application of the mark-to-market treatment.

Thus, conforming the financial accounting and tax timing rules for hedging entered into by companies subject to financial accounting reporting will require repealing the hedging exception from section 1256 and 475, and generally providing that all hedging transactions that are marked to market for financial accounting purposes would be marked to market for tax as well. In addition, where the hedged item is marked to market for financial accounting purposes, it would also be marked to market for tax.

With respect to taxpayers that are not subject to financial accounting reporting, I propose an elective mark-to-market approach (equivalent to

176. *See supra* Part II.
177. *See supra* Part IV.A–B.
178. *See supra* Part V.

section 475(f), that allows traders in securities to elect into mark to market with respect to securities). Obviously, such taxpayers will have a higher burden then the ones already subject to mark to market for financial accounting purposes because taxpayers that have never marked instruments to market will need new systems in place.

3. Identification

On the identification aspect, I suggest adopting the Camp Draft's proposal to conform the financial accounting and tax hedge identification rules. As set forth above, under the Camp Draft proposal, identification of a transaction as a "hedging transaction" for financial accounting purposes (including the proper identification of the hedged item) will satisfy the tax hedging identification requirement.[179] This means that the taxpayer will not need two separate identifications for financial accounting and tax purposes (as is the case today). As a result, fewer taxpayers will fail the identification rules and there will be fewer transactions that are true economic hedges but that do not satisfy the tax hedging rules merely because the taxpayer failed to identify the hedges properly.

Thus, to accommodate this change, the regulations will be amended to set forth that where a corporation identifies its hedging transactions and hedged items for financial accounting purposes, such an identification would qualify as a tax identification (and separate tax identification will not be needed).

Separately, for all taxpayers, I propose to clarify (and make more flexible) the inadvertent error rule. As of now, the standard appears to be very rigid, and taxpayer who fail to timely and properly identify an otherwise good hedging transaction are unable to get relief in many cases.

In my view, amending hedging identification should be no different than amending any other item on a tax return. Taxpayers should be eligible to go back three years and identify hedging transactions (as long as the substantive requirements are met). The Service could have the right to challenge the late identification on the grounds of taxpayer using hindsight, but the burden should be on the Service to show that a late hedge identification was not made properly.

---

179. Ways & Means Discussion Draft, *supra* note 132, at §402(a) (Prop. I.R.C. § 1221(c)(3)(B)); *supra* Part V.C.

B. Expand the Scope of the Definition of "Hedging Transaction" to Include Capital Assets

The expansion of the scope of hedging transactions to all assets (rather than only to ordinary assets) will apply to all taxpayers, including businesses and individuals. Obviously, if the proposed book-tax conformity is adopted, taxpayers subject to financial accounting reporting will see the same outcome whether the scope of hedging transaction is expanded to include capital assets or they simply follow their books.

In my view, there is no rationale to limit tax hedging rules to ordinary assets and liabilities. As the case law discussed above illustrates, taxpayers that hedged ordinary property or liabilities wanted the character of income and deductions from the hedging transaction to match the character of the income and deductions from the hedged items. In these cases, the hedged items were ordinary, so the taxpayers obviously asked the court to apply ordinary treatment to the hedging transactions at issue. Nevertheless, it should not follow that only ordinary assets and liabilities can be hedged.

In my view, Treasury and Congress "codified" the courts' decisions in a narrow way. Instead of limiting hedging transactions to ordinary property, the government should have adopted a general character matching principles, pursuant to which the character of income and deductions from the hedging transaction would match the character of income and deductions from the hedged item (whether ordinary or capital).

There is no apparent reason to exclude capital assets from the hedging rules. The purpose of the tax hedging rules is to match the character, not limit hedging treatment only to ordinary. As a practical matter, many taxpayers manage risk with respect to capital assets, and excluding such taxpayers from the hedging treatment is not justifiable.

Congress has recognized the need to adopt a more expansive view in both the straddle rules (the identified straddle regime) and section 1221(b)(2)(B). Nevertheless, it did not go one step further to plainly expand the scope of the hedging rules to all assets. Thus, I propose that capital assets will become qualified for the matching treatment under the tax hedging rules. All taxpayers (businesses and individuals) would benefit from expansion of the scope of the tax hedging rules to include such investment hedges.

The existing rules for taxing ordinary business hedges could serve as a model for taxing investment hedges. Thus, in terms of matching character of the hedging transaction with the hedged item, where the hedged item is a capital asset, gains and losses from both the hedging transaction and the hedged items should be capital, and where the hedged item is ordinary, the hedging transaction and hedged item would be taxed as ordinary, so that there would be no character mismatch.

If this expansion is adopted, section 1221(a)(7) would have to be repealed (because section 1221(a) only deals with ordinary assets), and a new Code section (and accompanying regulations) would have to set forth the revised hedging character rules. The proposed rule will simply provide that the character of income, gain, deductions, and losses from the hedging transaction will be the same as the character of income, gain, deductions, and losses from the hedged item, whether the hedged item is ordinary or capital.

I also suggest repealing Regulations section 1.1221–2(d)(5), which excludes from the definition of a "hedging transaction" the purchase or sale of a debt instrument, an equity security, or an annuity contract where the transaction limits or reduces the taxpayer's risk (or in other words, manages the taxpayer's risk) with respect to ordinary property, borrowings, or ordinary obligations. As long as the taxpayer can show that the purchase of the investment served a risk management purpose, there is no reason not to allow a taxpayer to manage a valid risk with such assets.

C. Exclusion from the Straddle Rules for Economic Hedges

If the above two proposals are adopted in their entirety, likely most if not all true economic hedges will be respected as such for tax purposes and will not be subject to the straddle rules. However, if some economic hedges are left outside the tax hedging rules (whether failing the substantive requirement or the identification requirement), it is proposed that such transaction will not suffer from the straddle consequences.

Congress specifically gave Treasury the authority in section 1221(2)(B) to issue regulations to properly account for transactions that are hedging transactions but have not been identified properly, or for transactions that were identified as hedging transactions but do not satisfy these substantive requirements to be treated as such. In other words, Congress acknowledged that the tax hedging rules may be too limited, and gave Treasury the authority to make them more flexible.

Thus, I propose that Treasury use its authority under section 1221(b)(2)(B) and exclude from the straddle rules those transactions that economically are entered into for risk management purposes but technically do not fall under the tax hedging rules. In such cases, a method similar to the identified straddle mechanism, where taxpayer would be able to offset gains and losses and not be subject to the harsh straddle rules could be implemented. If a taxpayer cannot show that it entered into the offsetting positions to manage risk, and all the other requirements of a straddle apply, such offsetting positions would be a straddle under the normal straddle rules.

The definition of the term straddle should contain an exception that any offsetting positions with respect to personal property entered into by the

taxpayer primarily to manage risk with respect to such property should not be treated as a straddle under section 1092.

VIII. CONCLUSION

Risk management is an activity that should be encouraged and supported by the government, and the most important element of such support should be providing efficient tax treatment to hedging transactions. However, the current tax hedging rules are too limited, incoherent, differ from financial accounting hedging principles, and do not accommodate risk management activities of too many taxpayers. Thus, the hedging rules must be modernized and expanded to allow more taxpayers and transaction to enjoy the matching principle.

The starting point should be to expand hedging treatment to all assets, not just ordinary assets. Additionally, companies subject to financial accounting reporting should be allowed to conform the book and tax treatment of their hedging activities. Furthermore, taxpayers who are truly hedging but fall under the scope of the tax hedging rules should not be subject to the harsh straddle rules. Finally, identification rules should be more flexible and not prevent taxpayers from being eligible for hedging treatment due to inadvertent errors.