TEI

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Taxation of Financial Instruments and Hedging Transactions : A Timely Refresher for Turbulent Times

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Introduction

What is capital markets tax?

Treasury issues such as risk management using derivative instruments

- Interest rates
- Commodity prices
- Foreign currency exchange rates

Foreign currency transactions and translation of multinational operations

- Nonfunctional currency transactions
- Branch or partnership operations conducted in a different currency

Domestic and cross-border financing activities

- Debt, equity, and hybrid financing structures
- Managing/repatriating cash
- Debt refinancings/modifications

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Why review capital markets tax areas?

Market dynamics and challenges have led to increased and more complex treasury risk management activities

Market fluctuations have resulted in material gains and losses on derivatives and the underlying hedged items

- Rising interest rates
- Volatile commodity prices and FX exchange rates

Greater financial statement impact and IRS scrutiny

- Financial statement footnotes on debt and derivative instruments
- Detailed domestic and international tax reporting
- Increased IRS Examination and standardized IDRs

Financial accounting and tax rules differ substantially

Reportable loss disclosures may be required

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Analytical Framework

Characterization
- What is it?
- One instrument or more?

Timing
- Realization
- Mark-to-market
- Loss deferral
- Matching

Character
- Ordinary
- Capital

Source
- US
- Foreign

Financial vs. Tax Accounting

Financial Accounting

- Preference for mark-to-market
- Preference for separate treatment for embedded derivatives

Tax Accounting

- Realization principal with limited mark-to-market, see e.g., 475, 1256
- Preference against separation and some permitted integration, but see swaps with significant nonperiodic payments treated as on-market, level payment swap and a loan

Derivatives

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Polling Question: What is a "derivative" for U.S. federal income tax purposes?

A. A bilateral (two-party) executory contract (a contract under which either or both parties must perform in the future, by delivering property or money) with a limited term (lifespan), the value of which is determined by reference to the price of one or more fungible securities, commodities, rates (such as interest rates), or currencies (an "underlying")

Polling Question: What is a "derivative" for U.S. federal income tax purposes?

B. A financial instrument or other contract with all three of the following characteristics:

- it has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required
- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement

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Polling Question: What is a "derivative" for U.S. federal income tax purposes?

C. A financial instrument or other contract with all three of the following characteristics:
- its value changes in response to changes in the so-called 'underlying', i.e. the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (in case of a non-financial variable, the variable must not be specific to a party to the contract)
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts with a similar response to changes in market factors
- it is settled at a future date

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Polling Question: What is a "derivative" for U.S. federal income tax purposes?

D. Any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following:

- Any share of stock in a corporation
- Any evidence of indebtedness
- Any commodity which is actively traded
- Any currency
- Any rate, price, amount, index, formula, or algorithm

Such term shall not include any item described above

Characterization: What is it?

- Debt
- Futures and Forward Contracts
- Equity
- Options
- Swaps

Characterization: One Instrument or More?

- Separation vs. Integration

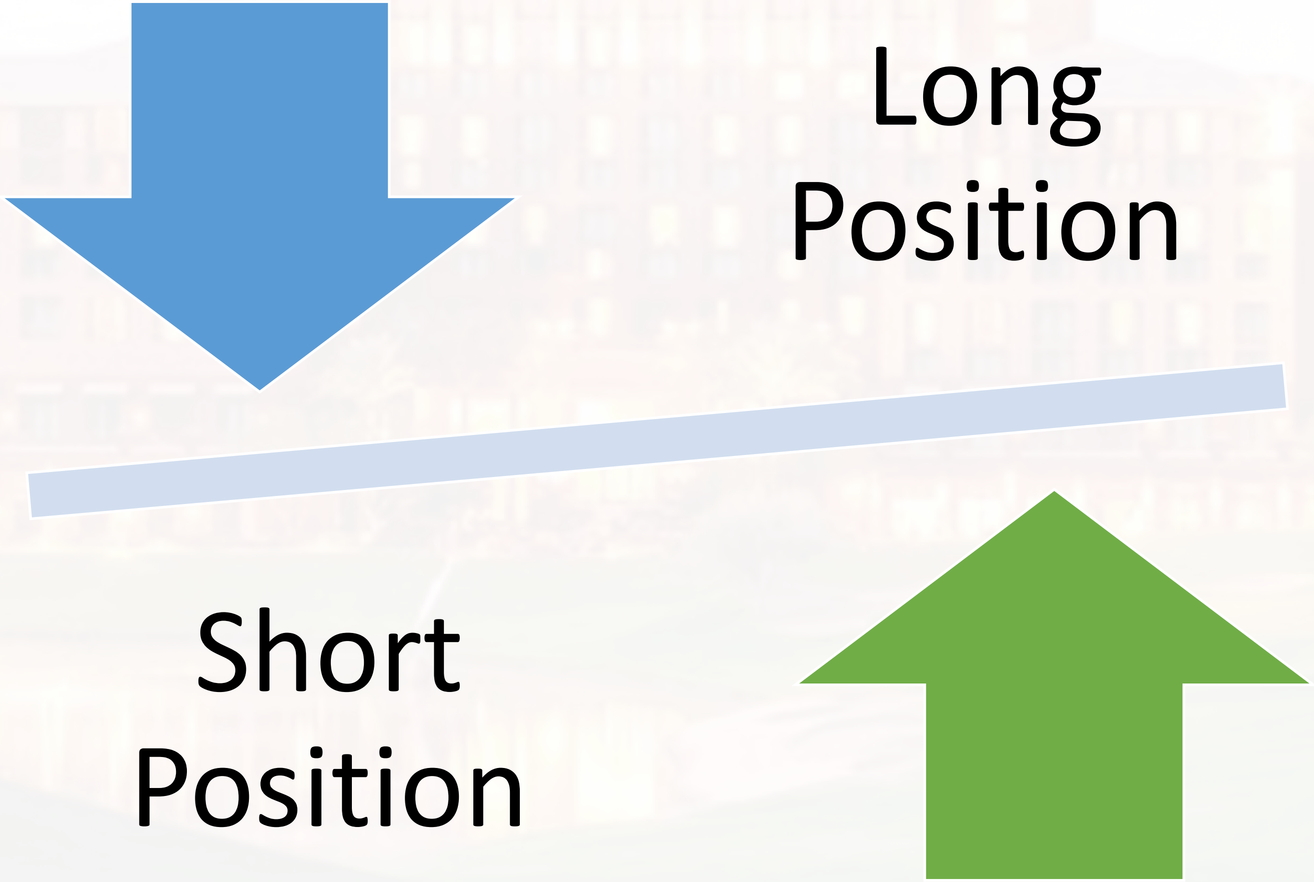
Bond + Warrant ≠ Convertible Bond

Characterization: One Instrument or More?

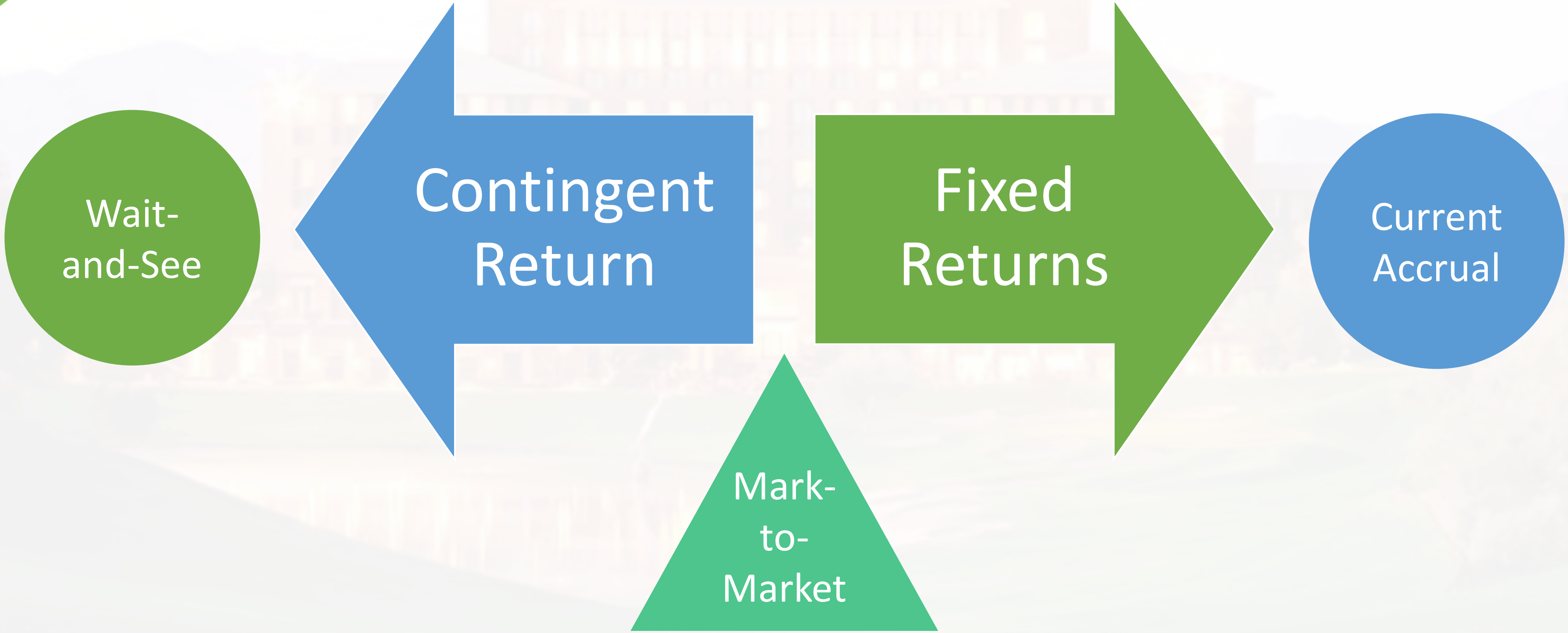
- Financial Equivalences / “Synthetic” Ownership

Stock + Put Right to Sell Stock at Strike Price of k ≠ Zero Coupon k Bond + Call Right to Purchase Stock at Strike Price of k

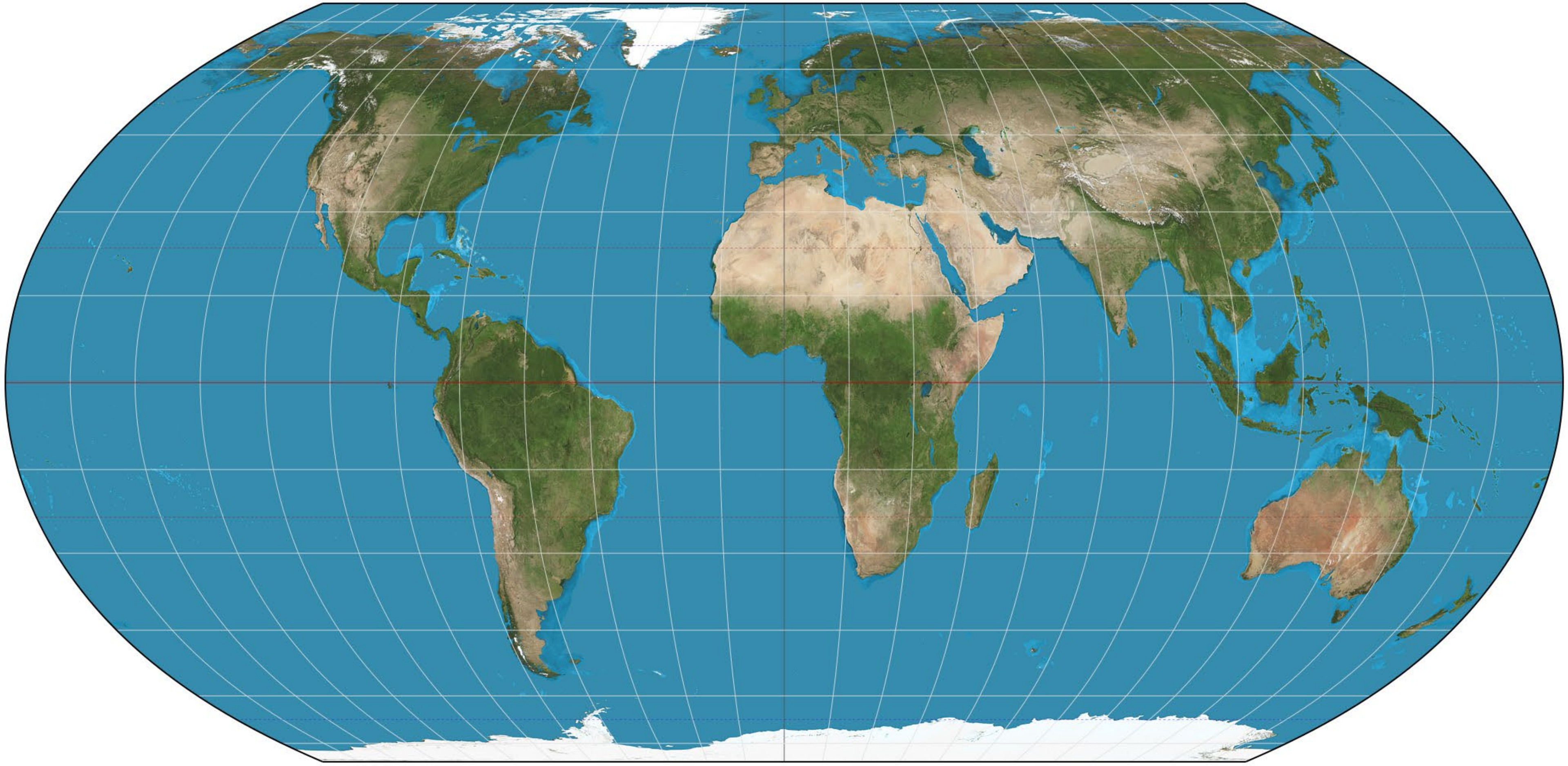
Balanced Positions



Timing of gain or loss recognition



International/Cross-Border



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Principal Tax Issues

Timing

Character

Source

Other Tax Issues

- Applicability of Subpart F
- Applicability of BEAT
- Foreign tax credit
- Withholding taxes

- Mark-to-market accounting: §§475 and 1256
- Anti-straddle rules: §1092
- Hedging transactions: §1221, Treas. Reg. §1.446-4, and Prop. Treas. Reg. §1.446-4
- Foreign currency transactions: §988 and Prop. Treas. Reg. §1.988-7
- Options and short sales: §§1233 and 1234
- Notional principal contracts: Treas. Reg. §§1.446-3 and 1.863-7
- Source rules for personal property sales: §865

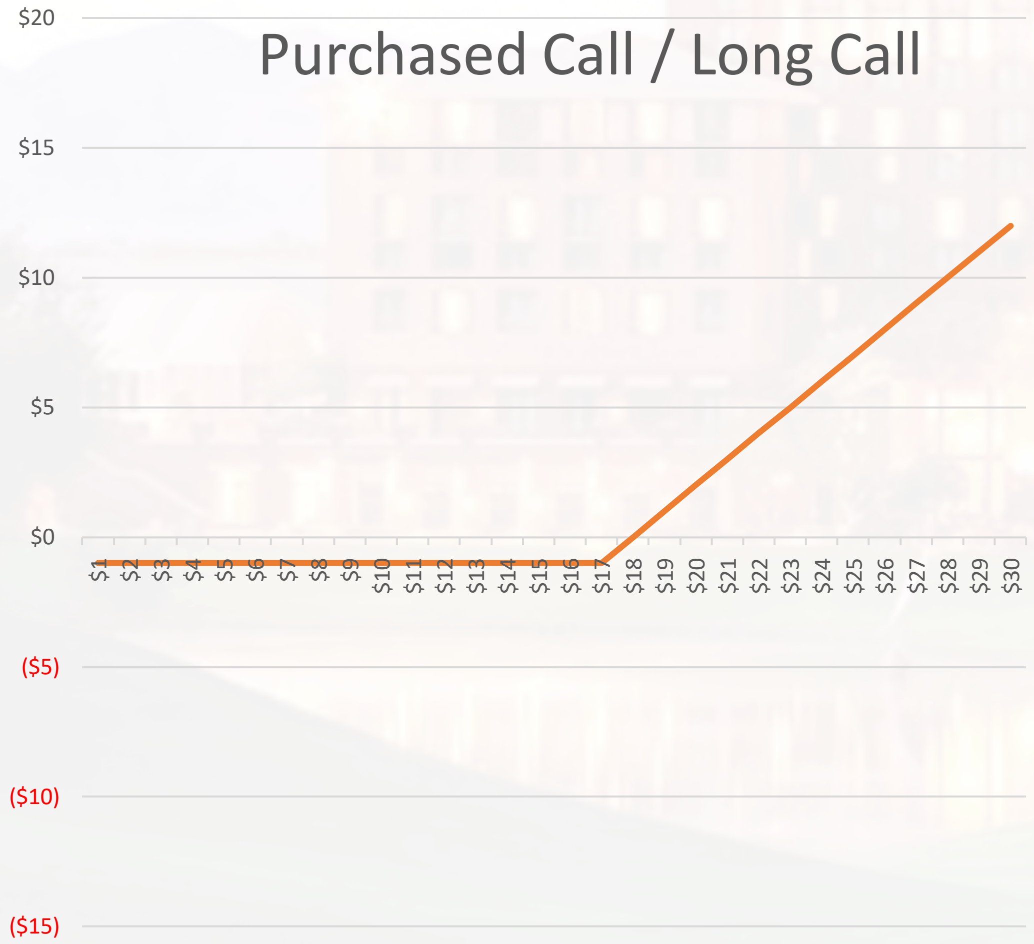
- Source rules for personal property sales: §865
- Interest expense apportionment: Temp. Treas. Reg. §1.861-9T(b)
- Constructive sales treatment for appreciated financial positions: §1259
- Foreign personal holding company income: §954(c), Treas. Reg. §1.954-2, and Prop. Treas. Reg. §1.954-2
- Interest expense limitations: §163(j) and regulations thereunder
- Other limits on deductibility BEAT: §59A

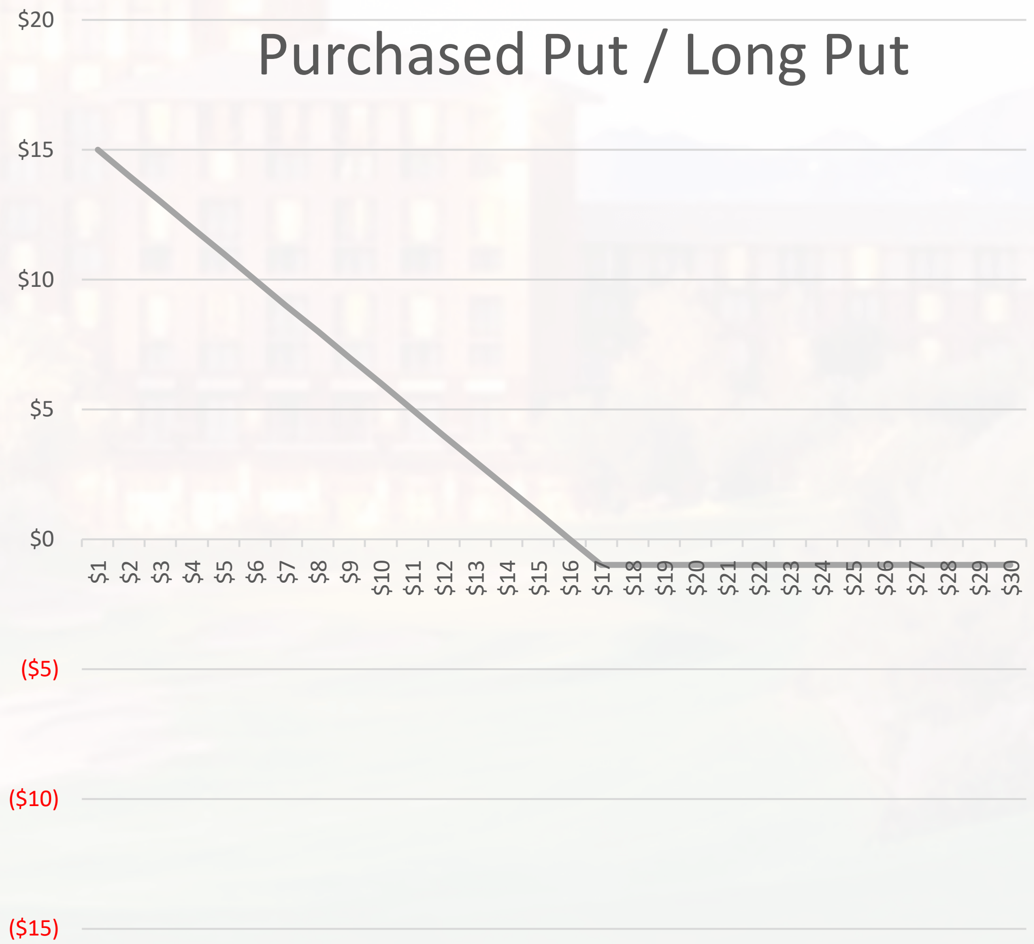
Options – Overview

- Holder has right, but not obligation, to buy (call) from or sell (put) property to grantor for a fixed price (strike price) during a fixed period/date.
- Most options are structured with “prepaid” premiums

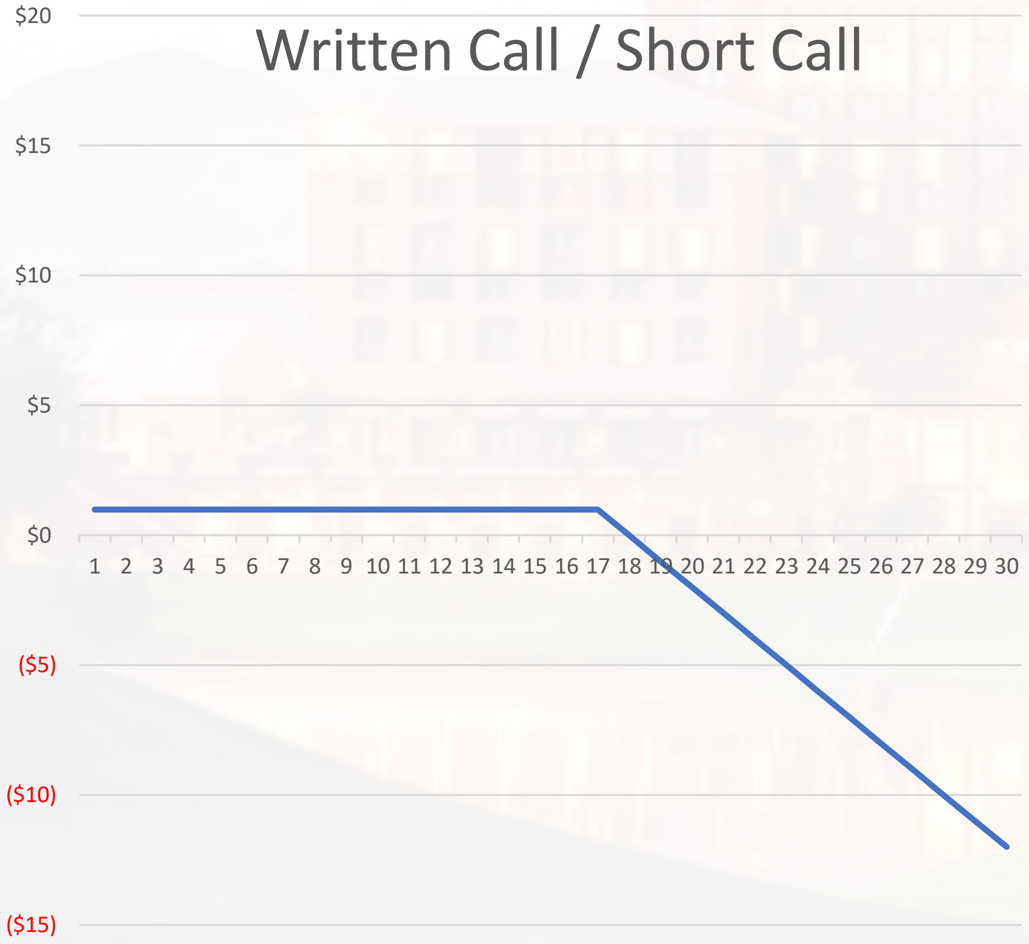
	Call	Put
Purchased/Long	• Right to purchase • Pay a premium	• Right to sell • Pay a premium
Written/Short	• Obligation to sell • Receive a premium	• Obligation to purchase • Receive a premium

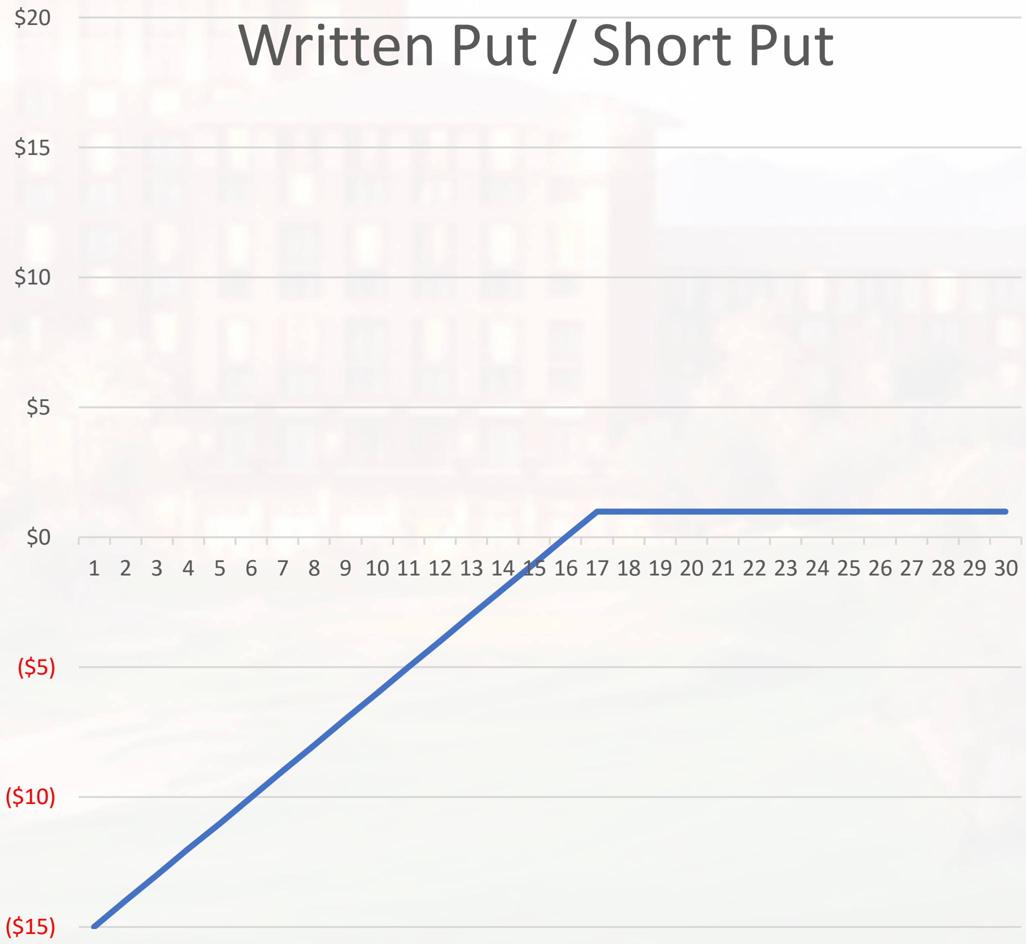
Options – Overview





Options – Overview





Options – Tax Rules

Timing

- No gain or loss on receipt/payment of premium
- Gain or loss on exercise, lapse, sale or exchange
- Consider straddle rules

Character and source

- Holder: look to character of underlying property
- Grantor: if exercised, look to underlying property; but if lapsed or sale/exchange, short-term capital
- Source based on residence of taxpayer

Futures and Forwards – Overview

- Executory contracts to buy/sell specified property at a specified price (forward price) and on a specified date, traditionally "postpaid"

Forward Price = Spot Price + Cost to Carry

- Futures are exchange traded and forwards are over the counter

Futures and Forwards – Tax Rules

Timing

- Mark-to-market under Section 1256
- Potential loss deferral under § 1092
- Consider hedging

Character and source

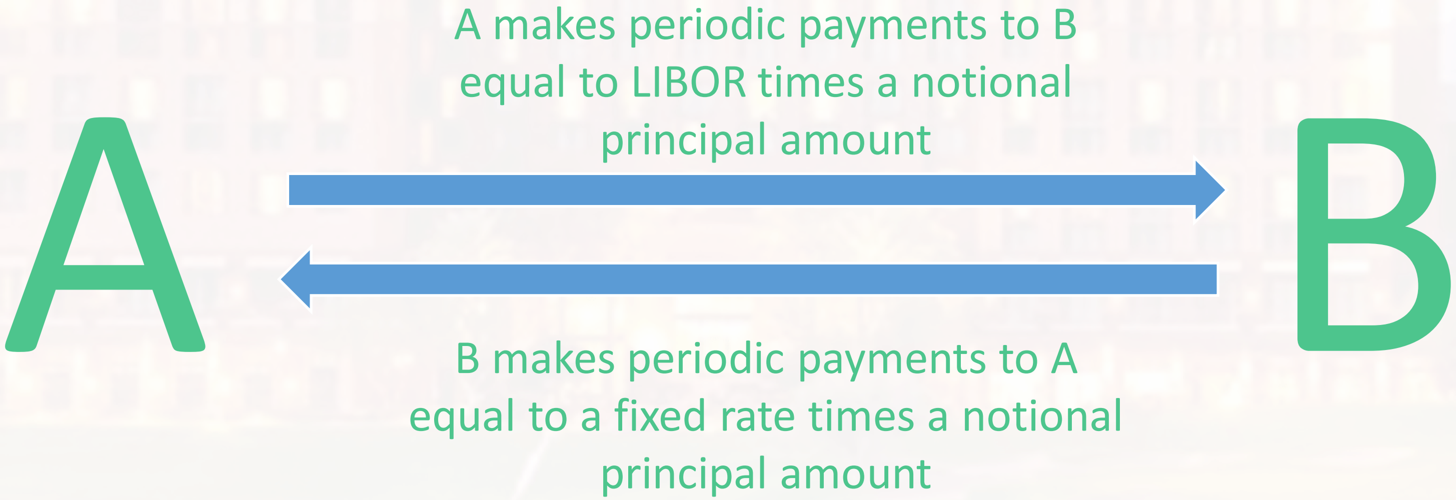
- Section 1256 contracts (futures)
  - 60% long-term capital, 40% short-term capital
  - Ordinary for FX if election made
- Forwards
  - Capital
  - Ordinary for FX (unless election made)
- Source based on residence of taxpayer

Notional Principal Contracts - Overview

- Provides for periodic payments based on notional principal amount and specified index in exchange for specified consideration

Interest Rate Swaps	Interest Rate Caps	Interest Rate Floors	Basis Swaps	Currency Swaps
Equity Swaps	Equity Index Swaps	Credit Default Swaps ?	Weather-Related Swaps ?	~~Bullet Swaps~~
~~Forward Contracts~~	~~Futures Contracts~~	~~Section 1256 Contracts~~	~~Options~~	~~Swaptions~~

Notional Principal Contracts – "Plain Vanilla" Interest Rate Swap



Notional Principal Contracts – Categories of Payments

Periodic Payments

- Payable at intervals of one year or less during the entire term of the contract
- Based on a *specified index*
- Based on either a single notional principal amount or a notional principal amount that varies in specified ways

Nonperiodic Payments

- Not a periodic payment
- Not a termination payment

Termination Payments

- Payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party

Notional Principal Contracts – More Categories of Payments

Nonperiodic Payments

- Fixed Payments
  - Front-End Nonsignificant Payments
  - Non-Front-End Nonsignificant Payments
  - Front-End Significant Payments
  - Non-Front-End Significant Payments
- Contingent Payments

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Notional Principal Contracts – Tax Rules

	Timing	Character	Source
Periodic Payments	Recognize ratable daily portions for taxable year to which portions relate	Ordinary	Based on residence of the taxpayer — i.e., the recipient of the income, but see § 871(m)
Nonperiodic Payments	Recognize ratable daily portions for taxable year to which portions relate, but significant nonperiodic payments may be recharacterized as loans	Ordinary	Based on residence of the taxpayer — i.e., the recipient of the income, but see § 871(m)
Termination Payments	Recognize in taxable year that contract is extinguished, assigned, or terminated	Capital, if contract is a capital asset in the hands of the taxpayer	Based on residence of the taxpayer — i.e., the recipient of the income, but see § 871(m)

Example of Significant Nonperiodic Payment

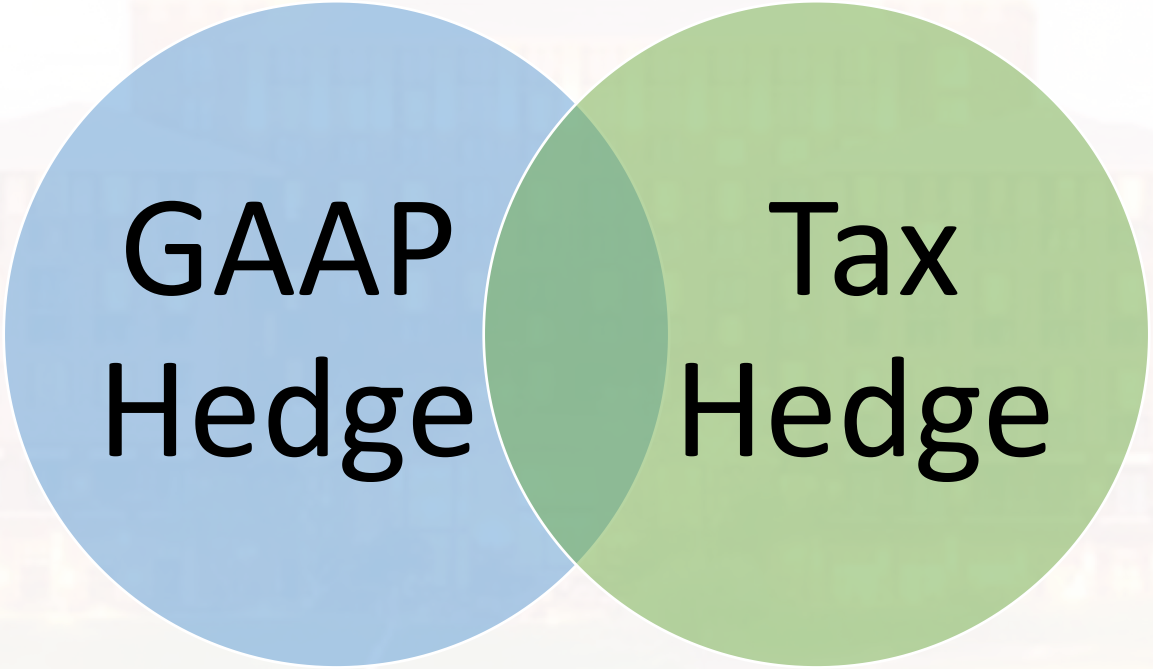
- N agrees to make five annual payments to M equal to LIBOR times a notional principal amount of $100 million.
- M agrees to pay N 6% of $100 million annually, plus an upfront payment of $15,163,147
  - On-market payment by N would be 10% of $100 million annually

Off-Market Swap: LIBOR-to-6% = **$15.2M Loan from M to N** + **On-Market Level Payment Swap**: LIBOR-to-10%

- $15,163,147 = present value, at 10% compounded annually, of five annual payments from M to N of $4,000,000 (4% of $100,000,000)

Hedging

Hedging



Differences in qualification and identification standards

Differences in timing of gain or loss recognition

Consider if the hedging entity has the underlying exposure

What is hedging?

- Managing business risk by entering into an offsetting position
- Business concept vs. tax requirements
- Tax requirements vs. GAAP requirements

What difference does it make?

- Can eliminate mismatches between exposure and hedge
  - Timing, character or source
- Can avoid generating Subpart F income
  - Commodities, currency, notional principal contracts
- Hedge payment may be excluded from BEAT
- Can avoid reduction in ability to credit foreign taxes

History of Tax Hedging

1933
Pre-1934, little practical relevance because of two-year holding period for capital treatment

1934
The Revenue Act of 1934 eliminated holding period requirement

1955
Case law and administrative rulings develop to limit whipsaws, including *Corn Products* Doctrine (i.e., exception from capital asset treatment for assets held as an integral part of taxpayer's business)

1988
Arkansas Best case in 1988 held that an asset is capital unless it falls within one of the specifically enumerated exceptions in § 1221, essentially denying the *Corn Products* Doctrine existed

1993
Fannie Mae case in 1993 held that liability hedging transactions at issue were "integrally related" to a § 1221(a)(4) asset and therefore should receive ordinary treatment

1993 temporary regulations

1994
1994 final regulations, including risk reduction standard

1999
Enactment of § 1221(a)(7 and (b)(2) as part of the Tax Relief Extension Act of 1999, including risk management standard

2001
2001 proposed regulations used words "risk management" but provided that transactions that do not reduce risk do not manage risk

2002
2002 final regulations, provide that transactions that reduce risk satisfy risk management standard and identify specific transactions that satisfy the risk management standard (e.g., interest rate conversions)

Tax Hedging Requirements

Transactions entered in normal course of business primarily to manage taxpayer’s risk of:

- Price changes or currency fluctuations with respect to “ordinary property” held or to be held
- Interest rate, price changes, or currency fluctuations on borrowings or “ordinary obligations” incurred or to be incurred
- Other risks that the IRS identifies in published guidance (none issued).

Hedged item must be “ordinary” property or obligation, *i.e.*, it cannot give rise to capital gain or loss

- Hedging treatment not available for hedges of ordinary income streams from capital assets
- *But see* Treas. Reg. § 1.954-2(a)(4)(ii)(A) definition of “bona fide hedging transaction” includes § 988 transactions, including nonfunctional currency loan receivables, and § 1231 property

Risk Management Requirement

Risk management based on "all of the facts and circumstances surrounding the taxpayer's business and the transaction"

Transactions that <u>may be</u> entered into primarily to manage risk				Transactions that <u>are not</u> entered into primarily to manage risk		
Risk reduction transactions	Interest rate conversions	Transactions that counteract hedging transactions	Recycling (i.e., using an old hedging transaction to hedge another asset)	Purchase and sale of a debt instrument	Purchase and sale of an equity security	Purchase and sale of an annuity contract

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Risk Management Requirement

Risk reduction transactions

- Assessment must take into account all operations
- Hedge of a particular asset or liability if (i) reduces risk attributable to such asset or liability and (ii) is reasonably expected to reduce overall risk of operations
- Hedge of a particular asset or liability, <u>or group of assets or liabilities,</u> if undertaken as part of a program that, as a whole, is reasonably expected to reduce overall risk of operations (no need to prove risk reduction with respect to every hedge)
- Interest rate conversions (*i.e.*, fixed-to-floating/ floating-to-fixed)
- Transactions that counteract hedging transactions (*i.e.*, used to offset prior hedging transaction)
- Recycling (*i.e.*, old hedging transaction repurposed to hedge a different asset)

Who is the hedger?

U.S. Consolidated group treated as single entity absent election

- Risk of one member is treated as the risk of the other members
- Intercompany transactions not considered hedging transactions

Separate entity election available

- Risk of one member is not treated as the risk of other members
- Intercompany transactions may be considered hedging transactions of a member if (1) the position would qualify as a hedging transaction with respect to the member if entered into with an unrelated party, and (2) the position of the other member is marked to market

Non-consolidated entities and controlled foreign corporations

- Separate company risk assessment
- US parent cannot hedge the risk of its CFCs

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ISDA Documentation

- For derivative transactions traded directly between two parties (OTC derivatives transactions), the International Swaps and Derivatives Association, Inc. ("ISDA") publishes the most commonly-used documents

Master Agreement

Printed form agreement structured like a bilateral credit agreement

Schedule

Specific elections under the Master Agreement (e.g., governing law) and modifications to Master Agreement

Short-Form Confirmation

Confirms transactions that have been entered orally or electronically (provides for certain specific elections under the Master Agreement (e.g., governing law) and modifications to Master Agreement

Long-Form Confirmation

Functions as both schedule and confirm, utilized in one-off transactions

Credit Support Annex

- Creates a security interest over collateral
- Contains provision of margin

ISDA Definitional Booklet

- Provides product specific definitions

Protocols

- Provide mechanism for implementing amendments without bilateral negotiations

ISDA Documentation (cont'd)

Establish the legal and factual basis for exemption from withholding taxes

- Representations
- Delivery of tax forms

Allocate financial burden of any withholding tax that is imposed

Allow "innocent" party that would otherwise bear burden of tax to terminate

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Identification Requirement

Same-Day Identification of Hedging Transactions	Substantially Contemporaneous Identification of Hedged Item	Additional Hedge Timing Identification
• Hedging transactions must be clearly identified as a tax hedging transaction under Treas. Reg. §1.1221-2 not later than the close of the day on which the transaction is entered into	• Hedged item, items or aggregate risk must be identified substantially contemporaneously with entering into the hedging transaction; not substantially contemporaneously if more than 35 days after entering the hedging transaction	• Taxpayer books and records must contain specific identification necessary to verify the application of the method of accounting used

Necessary to be treated as a hedging transaction

Identification Requirement (cont'd)

Separate and Explicit Identification

Hedge Identification System

Illustrations

- Designated hedge account
- One-time statement extending to all future transactions in a specified derivative product
- Designated mark on record of transaction (such as trading ticket, purchase order, or trade confirmation)

Identification Requirement (cont'd)

Unambiguous identification	• Presence of an identification must be unambiguous
Identification for financial accounting purposes not sufficient	• May be harmful
Whipsaws for improper identifications and failures to identify	• All gains treated as ordinary, all losses subject to the general tax rules (generally, capital)
Exception if failure to identify or improper identification due to inadvertent error	• Narrowly construed by the IRS

Special Rules

Hedging by CFCS — § 954(c)(1)(C), (D), and (F); Treas. Reg. § 1.954-2 and Prop. Treas. Reg. §§ 1.954-2 and 1.446-4

Integration — §988(d)/Treas. Reg. §§ 1.988-5 and 1.1275-6

Liability Hedging — Temp. Treas. Reg. § 1.861-9T(b)(6)

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Hedge timing Rules

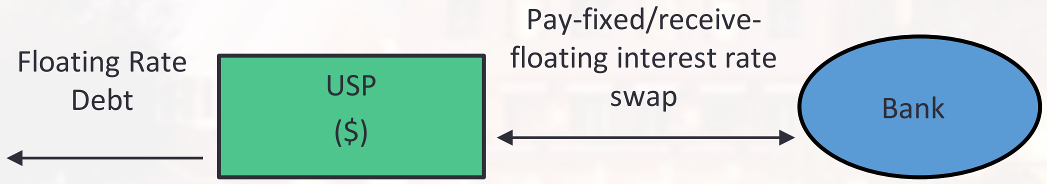
- Governed by Treas. Reg. § 1.446-4
- Income, deduction, gain/loss on hedge must be "reasonably matched" to hedged item

Hedges of aggregate risk	Hedge of debt instrument	Hedge using notional principal contract	Hedge of anticipated transactions
• Gain/loss with respect to hedging transaction that is not associated with any particular item being hedged must be matched with the aggregate gain/loss from the items being hedged	• Gain/loss accounted for by reference to the terms of the debt instrument and period(s) to which hedge relates (i.e., constant yield method)	• Gain/loss generally accounted for under the notional principal contract regulations (Treas. Reg. § 1.446-3)	• Where transactions not consummated, gain/loss taken into account when realized

Hedge timing Rules

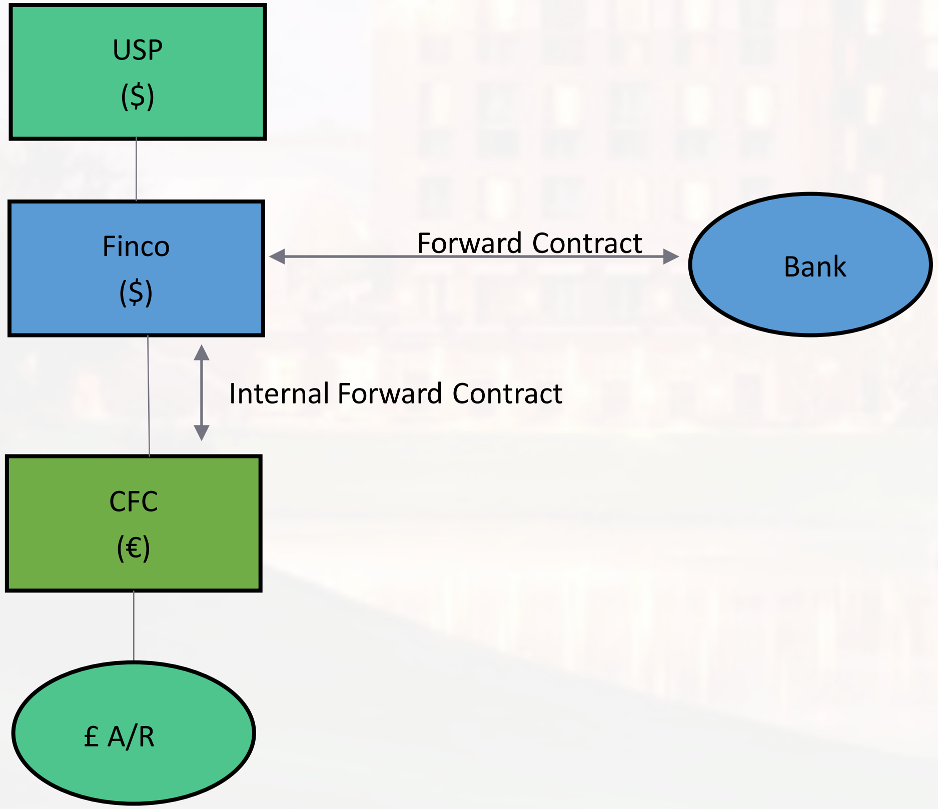
	Legging in	Legging out
Concept	• The taxpayer enters into a hedging transaction by recycling a hedge of a particular hedged item to serve as a hedge of a different item	• The taxpayer sells or terminates its interest in the hedged item but doesn't dispose or terminate the hedging transaction.
Tax impact	✓ The taxpayer must match the built-in-gain/loss at the time of the recycling to the gain/loss on the original hedged item, items or aggregate risk. ✓ Income, deduction, gain or loss attributable to the period must be matched to the new hedged item.	✓ The taxpayer must match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item. ✓ Special rules apply if the taxpayer intends to dispose of the hedging transaction within a reasonable period (generally 7 days).

Tax Hedging Example 1



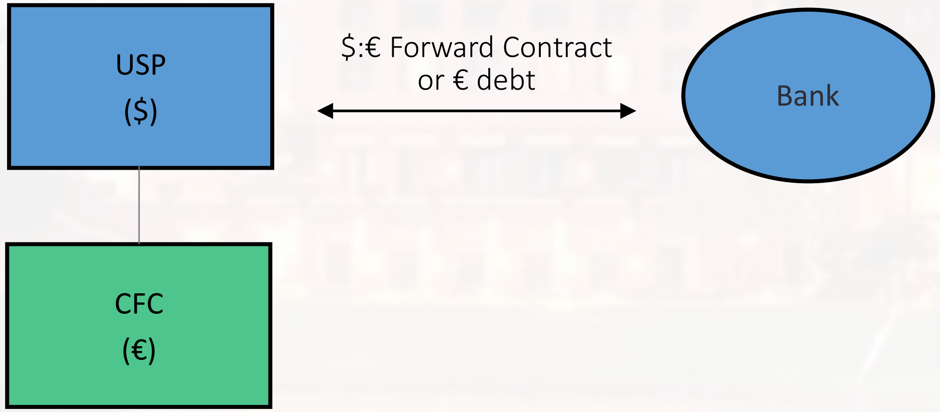
- Treasury
  - Goal — manage risk of interest rate fluctuations with respect to floating-rate debt
- Financial Accounting
  - Designated as cash flow hedge
  - Gain/loss on hedge recorded to other comprehensive income (to the extent effective)
- US Federal Income Tax
  - Can be identified as a hedging transaction under § 1221
    - Any gain/loss on hedge treated as ordinary income/loss
  - Timing of any gain or loss generally can match the cash flow hedge accounting treatment

Tax Hedging Example 2



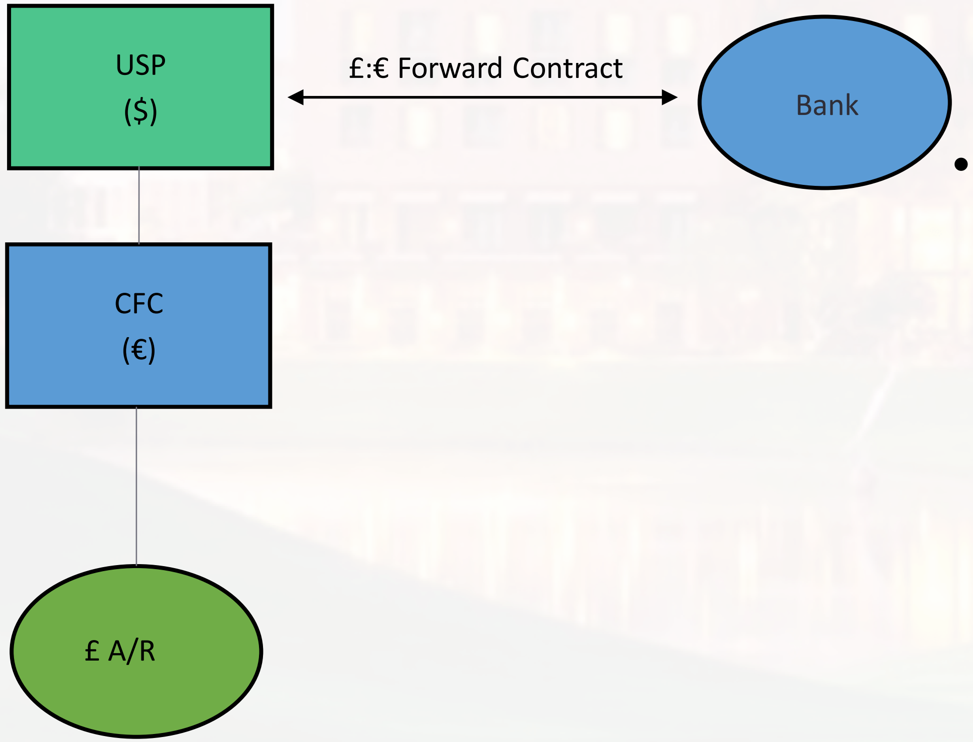
- Treasury
  - Goal — manage balance sheet risk from changes in GBP/EUR FX rate
- Financial Accounting
  - Generally eligible for hedging treatment
- US Federal Income Tax
  - Finco
    - §§ 1256 and 1092 — potential timing mismatch unless documented properly
    - But consider application of § 475 timing rules
  - CFC level
    - Net FX gains on A/R and internal forward are foreign personal holding company income unless business needs exception applies
    - Identification and documentation required

Tax Hedging Example 3



- Treasury
  - Goal — manage risk of net investment in EUR-denominated CFC
- Financial Accounting
  - Designated as hedge of net investment in EUR CFC
  - Gain/loss on forward recorded to other comprehensive income
- US Federal Income Tax
  - Generally, ineligible for hedging treatment (not an ordinary asset or liability
  - General realization and recognition rules apply (e.g., §§ 988, 1001, 1092, 1256, etc.)

Tax Hedging Example 4



- Treasury
  - Goal — manage balance sheet risk from changes in GBP/EUR FX rate
- Financial Accounting
  - Generally, remeasured under ASC 830
  - Gain/loss on forward and loss/gain on A/R included in earnings
- US Federal Income Tax
  - Generally, ineligible for hedging treatment (not a risk of the taxpayer)
  - § 1256 — forward contract may be marked-to-market, accelerating gains
  - § 1092 — losses may be deferred if unrecognized gain in offsetting position
  - Potential ETR disparities
  - Character, if § 988 not applicable

Key Questions, Issues, and Opportunities

- ✓ Any hedges that qualify for book, but not tax (or vice versa)?
- ✓ Any hedging transactions have built-in gains that can be monetized while deferring the gain for tax purposes?
- ✓ Any hedging transactions settled or deemed settled early?
- ✓ Any hedging by foreign entities?
- ✓ Is the hedging entity, the entity with the exposure?
- ✓ What is the accounting for hedging transactions?
- ✓ Any tax hedging identification statements?

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