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MEMORANDUM TO OUR CLIENTS

Brown & Wood LLP January 26, 2001

Re: Proposed Changes to the Deductiblility of Interest and Carrying Charges With Respect to Straddle Positions and Other New Rules

On January 17, 2001, the Treasury Department issued proposed regulations under sections 263(g) [1] and 1092 (the "Proposed Regulations"), proposing broad changes to the rules relating to the deductibility of interest, swap payments and other costs associated with financial positions constituting a tax straddle. The Proposed Regulations were published in the Federal Register on January 18, 2001. The Proposed Regulations, if adopted, could affect the ability of issuers to deduct interest paid or accrued on many exchangeable debt instruments and certain other contingent payment debt instruments.[2] Additionally, if adopted, the Proposed Regulations will deny participants in certain financial structures the ability to deduct net swap payments and certain other expenses.

The Treasury Department also issued proposed regulations relating to hedging transactions on January 17, 2001 (the "Hedging Regulations"). The Hedging Regulations reflect changes made to section 1221 by Congress in December, 1999.[3] The Hedging Regulations provide that property that is part of a hedging transaction (i.e., property that reduces certain economic risks of the taxpayer), will not be treated as a capital asset, and gain or loss from its sale will produce ordinary income or loss as opposed to capital gain or loss.

In addition, the IRS recently issued proposed regulations that would expand the exemption from the straddle rules for qualified covered call options (the "QCC Regulations") involving options with flexible terms ("flex options") and certain over the counter ("OTC") equity options.[4] The QCC Regulations will generally become effective 30 days after the

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[1] All section references are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

[2] Proposed Treasury regulation section 1.263(g)-2, Proposed Treasury regulation section 1.263(g)-3, Proposed Treasury regulation section 1.263(g)-4, and Proposed Treasury regulation section 1.263(g)-5.

[3] Section 532 of the Ticket to Work and Work Incentives Improvement Act of 1999 (December 17, 1999) (113 Stat. 1860).

[4] Proposed Treasury regulation section 1.1092(c)-1, Proposed Treasury regulation section 1.1092(c)-2, and Proposed Treasury regulation section 1.1092(c)-3.

regulations are published in final form. The QCC Regulations would also limit qualified covered call status to options with a term of one-year or less. With respect to listed options with standardized terms, this part of the regulation generally is proposed to become effective 90 days after the QCC Regulations are published in final form.

I. Proposed Regulations Under Section 263(g)

A. General

Section 263(g)(1) disallows a deduction for "interest and carrying charges properly allocable to personal property which is part of a straddle," and provides that such disallowed expenses are added to the basis of the personal property in question (i.e., the costs are capitalized as opposed to being currently deducted). A straddle is defined as "offsetting positions" with respect to actively traded personal property.[5] A taxpayer is treated as holding offsetting positions if there is a "substantial diminution of risk of loss" from holding any position with respect to actively traded personal property by holding another position with respect to actively traded personal property. A "position" is an interest in personal property, including but not limited to a futures or forward contract or an option.[6]

Section 263(g) was enacted to prevent taxpayers from currently deducting interest and carrying charges attributable to "cash and carry" straddles. In the typical cash and carry scenario, the taxpayer borrows to purchase a commodity (e.g. gold) and simultaneously sells gold forward on a future date for a fixed price. In the absence of section 263(g), even though the taxpayer's economic position would not have changed, the taxpayer would claim current interest deductions (from ordinary income) and then a capital gain at the end of the transaction.

B. Special Rule for Debt Instruments.

One of the critical aspects of the Proposed Regulations is a change made to the section 1092 straddle regulations. The Proposed Regulations explicitly provide that an obligation under a debt instrument may be a "position" in personal property that is part of a straddle.[7] Specifically, the Proposed Regulation states, "[i]f a taxpayer is the obligor under a debt instrument one or more payments on which are linked to the value of personal property or a position with respect to personal property, then the taxpayer's obligation under the debt instrument is a position with respect to personal property and may be part of a straddle." This provision, if adopted, will bring many exchangeable debt instruments and certain contingent payment debt instruments into the definition of a straddle.[8]

In the case of some contingent payment debt instruments, however, the issuer may be able to integrate the debt instrument and related hedges for tax purposes under Treasury

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5 Section 1092(c).
6 Section 1092(d)(2).
7 Proposed Treasury regulation section 1.1092(d)-1(d).
8 The expanded definition of a straddle will technically also include conventional exchangeable debt (i.e., where a parent corporation issues debt exchangeable into stock of its subsidiary corporation).

Regulation 1.1275-6.[9] This will, in many cases, exempt the transaction from the adverse consequences imposed by the straddle rules, including section 263(g). This is because Treasury Regulation 1.1275-6 sets forth special rules that apply to transactions that are integrated to form synthetic debt instruments. A synthetic debt instrument is a hypothetical debt instrument with cash flows created from combining the cash flows on a "qualifying debt instrument" and a "1275-6 hedge." In order to obtain this special treatment, the combined cash flows from the two positions must be substantially equivalent to the cash flows on a fixed or variable rate debt instrument. A "qualifying debt instrument" is any debt instrument except certain tax-exempt obligations, certain interests in or mortgages held by REMICs and certain contingent payment debt instruments issued for non-publicly traded property.[10] When a qualifying debt instrument is integrated with a 1275-6 hedge under Treasury regulation 1.1275-6, the integrated transaction is treated as a single transaction and neither the qualifying debt instrument nor the 1275-6 hedge will be subject to either the straddle rules or section 263(g) on a separate basis.[11] However, in order to be part of an integrated transaction, neither the qualifying debt instrument nor the 1275-6 hedge can be part of a straddle prior to the issue date of the synthetic debt instrument.[12]

Since the scope of the Proposed Regulations is so broad, many non-abusive transactions may be unintentionally subject to the harsh effects of section 263(g). When such transactions arise, it may prove advisable to attempt to restructure the transaction to fit within one of the exceptions to the straddle rules.[13] The exceptions include, synthetic debt (as described immediately above), qualified covered call options (described below), and hedging transactions (described below). Additionally, it is important to note that while the straddle rules do apply to section 475 dealer positions, section 263(g) does not.[14] Thus, straddles effected by a mark-to-market dealer generally will not be impacted by section 263(g).

Many practitioners had, in the past, advised clients that even if a contingent payment debt instrument was found to be part of a straddle as to the issuer (which most believed should not have been the case under prior law), section 263(g) would still not affect the ability of the issuer to deduct the related interest expense (provided the offsetting position, such as stock, was not pledged as collateral for the borrowing). This was due to the fact that section 263(g) requires the capitalization of interest and carrying charges "properly allocable" to personal property that is part of a straddle. "Interest and carrying charges" is defined as the net cost attributable to the sum of interest on indebtedness incurred or continued to "purchase or carry" the personal property and all other amounts similarly paid or incurred to "carry" such property (including costs to insure, store, or transport the personal property), over the sum of interest, dividends and certain other items of income arising from the personal property ("allowable offsets").[15] The popular thinking was that under section 263(g), interest and carrying charges would only be

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9 See Treasury regulation section 1.1275-6.

10 Treasury regulation section 1.1275-6(b).

11 Treasury regulation section 1.1275-6(f). However, the integrated transaction, with the cash flows of the synthetic debt instrument, may itself be part of a straddle and may be subject to section 263(g).

12 Treasury regulation section 1.1275-6(c)(1)(vii). The issue date of the synthetic debt instrument is the first date the taxpayer enters into all components of that instrument. Treasury regulation section 1.1275-6(f)(2).

13 Section 263(g) only applies to positions in a straddle. Additionally, the section 263(g) regulations specifically exempt hedging transactions and securities to which the mark-to-market accounting method provided by section 475 applies. See Proposed Treasury regulation section 1.263(g)-1(b).

14 Proposed Treasury regulation section 1.263(g)-1(b).

15 Section 263(g)(2).

"properly allocable" to personal property if the proceeds of the borrowing were used to "purchase or carry" the personal property (e.g., the appreciated stock). That is, section 263(g) would only require the capitalization of interest if the issuer utilized the borrowing proceeds to purchase the underlying stock or secured the borrowing with such stock. The Proposed Regulations change the rules to make clear that interest charges will be "properly allocable" to personal property if payments on the indebtedness are determined by reference to the value, or change in value, of the personal property that is part of the straddle.[16]

As discussed later in this memorandum, any thought of evading the reach of the Proposed Regulations by executing a transaction with a financial instrument other than a debt instrument, such as a swap, is equally foreclosed. The Proposed Regulations provide that "interest and carrying charges" include "otherwise deductible payments or accruals on financial instruments that are part of a straddle or that carry part of a straddle."[17] The Proposed Regulations expand upon this, stating that "financial instruments that are part of a straddle or that carry part of a straddle" include, (i) otherwise deductible payments or accruals on debt or financing issued or continued to purchase or carry personal property that is part of a straddle, (ii) otherwise deductible fees or expenses for acquiring or holding personal property that is part of a straddle, and (iii) other otherwise deductible payments or accruals on financial instruments that are part of a straddle or that carry part of the straddle.[18]

Even if a financial instrument is not part of the straddle but is deemed to "carry" part of the straddle, payments on such instrument will not be currently deductible. The Proposed Regulations set forth the following example. On January 1, 2002, D enters into a contract to deliver x barrels of heating oil to E on July 1, 2004, at an aggregate price equal to $y. Soon afterwards, D issues a contingent payment debt instrument to F with a principal amount of $z and a 2-year term that pays interest quarterly at a LIBOR based rate adjusted by an index that varies inversely with changes in the price of fuel oil. Therefore, the change in the aggregate amount of interest paid on the debt instrument will approximate the concurrent change in the value of D's interest in the forward contract. The debt instrument and the forward contract will, under the Regulations, constitute a straddle. Consequently, D's interest payments on the debt instrument are not currently deductible but must be added to D's basis in the forward contract. Now, assume also that on January 1, 2002, D enters into a two-year floating for fixed interest rate swap under which D receives LIBOR on a notional amount equal to $z in exchange for payments by D at 7%. Because of the relationship between the two-year debt instrument (which constitutes one leg of a straddle) and the interest rate swap, the interest rate swap is considered a financial instrument that "carries" personal property that is part of a straddle (i.e., the debt instrument). Thus, net payments made by D under the interest rate swap will not be currently deductible by D but must be added to D's basis in the forward contract.

The effect of the Proposed Regulations may be avoided with financial instruments that do not provide for current payments, such as pre-paid forward contracts, options, and certain other instruments. Of course, these instruments may still constitute one leg of a straddle. Since they do not generate current deductions, however, they do avoid the capitalization rule of section

16 Proposed Treasury regulation section 1.263(g)-3(c)(3).
17 Proposed Treasury regulation section 1.263(g)-3(b)(3).
18 Proposed Treasury regulation section 1.263(g)-3(d).

263(g) (because there are no payments to capitalize). For example, a taxpayer who holds an appreciated position in publicly traded stock and desires to monetize his position may enter into a pre-paid forward contract with respect to such stock. Assuming the forward contract is of a "variable share" structure such that a constructive sale of the underlying stock pursuant to section 1259 is avoided, the taxpayer has monitized his position in a tax-free manner and avoided section 263(g). Additionally, the taxpayer in the example could have borrowed against his stock position on a non-recourse basis. This would provide the taxpayer with the desired cash and would not constitute a straddle. Thus the taxpayer generally should be permitted interest deductions on the borrowing despite the embedded put option in the non-recourse note.[19]

C. Proposed Treasury regulation section 1.263(g)-2 – Expansion of the definition of "personal property" for purposes of section 263(g).

The Proposed Regulations define "personal property" more broadly than the straddle rules under section 1092. Section 1092 defines personal property as any personal property of a type that is actively traded. However, section 1092 also applies to "interests in" personal property even if the interest itself is not of a type that is actively traded.[20] Thus, for example, publicly traded stock and a non-publicly traded option on such stock may constitute a straddle. Section 263(g), on the other hand, only requires the capitalization of interest and carrying charges properly allocable to personal property, not "interests in" personal property. In order to require the capitalization of more costs associated with a straddle, the definition of personal property under section 263(g) was expanded to reach many more types of financial instruments that may form a part of a straddle. The Proposed Regulations adopt a common law interpretation of "personal property" for purposes of section 263(g). The new expanded definition includes any property right, whether or not actively traded, other than a right in real property. This definition includes both financial positions that provide substantial rights but do not impose substantial obligations on the holder (e.g., common stock or a purchased option) and executory contracts that impose both rights and obligations on the holder (e.g., notional principal contracts (swaps) and forward contracts). However, the definition of personal property excludes financial positions that impose only obligations on the taxpayer (e.g., the obligor's position in a debt instrument or a writer's position in an option).

D. Proposed Treasury regulation section 1.263(g)-3 – Expansion of the type of payments that are subject to capitalization pursuant to section 263(g).

The Proposed Regulations generally require the capitalization of any and all otherwise deductible payments arising with respect to, or in conjunction with, a straddle. Section 263(g) has, since its introduction in 1981, required the capitalization of "interest incurred or continued to purchase or carry the personal property" and all other amounts paid or incurred to "carry" the

[19] Current thinking in the federal income tax law would not seek to bifurcate a non-recourse note into a combination of a debt instrument and a put option. However, the reality exists that if the value of the stock falls below the face amount of the debt, the taxpayer has the option of defaulting and permitting the borrower to foreclose on the collateral.

[20] See section 1092(d)(2) (A position in actively traded personal property includes an interest in such personal property including, but not limited to, a futures or forward contract or an option.)

personal property that is part of a straddle.[21] The Proposed Regulations expand the meaning of this notion. Accordingly, pursuant to the Proposed Regulations, interest and carrying charges subject to capitalization include, (i) otherwise deductible payments or accruals (including interest and OID) on indebtedness or other financing issued or continued to purchase or carry personal property that is part of a straddle, (ii) otherwise deductible fees or expenses paid or incurred in connection with acquiring or holding personal property that is part of a straddle including, but not limited to, fees or expenses incurred to purchase, insure, store, maintain or transport the personal property, and (iii) otherwise deductible payments or accruals on financial instruments that are part of a straddle or that carry part of a straddle.[22]

By adding certain financial instruments that are part of, or carry part of, a straddle to the list of expenses subject to capitalization, the Proposed Regulations expand the scope of section 263(g).[23] The Proposed Regulations explain that the financial instruments captured by this expansion include: (i) a financial instrument that is part of a straddle, (ii) a financial instrument issued in connection with the creation or acquisition of a position in personal property if that position is part of the straddle; (iii) a financial instrument that is sold or marketed as part of an arrangement that involves a taxpayer's position in personal property that is part of the straddle and that is purported to result in either economic realization of all or part of the appreciation in an asset without simultaneous recognition of taxable income or a current tax deduction (for interest, carrying charges, payments on swaps, or otherwise) reflecting a payment or expense that is economically offset by an increase in value that is not concurrently recognized for tax purposes or has a different tax character (for example an interest payment that is economically offset by an increase in value that may result in a capital gain in a later tax period), and (iv) any other financial instrument if the facts and circumstances indicate that it was issued, purchased, or continued by the taxpayer with the intention of purchasing or carrying personal property that is part of a straddle.[24] This new construction of section 263(g) is very broad and will generally force the capitalization of all costs (whether paid or accrued) on most financial instruments issued in connection with (or anywhere near) a straddle. Thus, for example, not only must all interest expenses associated with certain contingent payment debt instruments be capitalized regardless of the issuer's use of proceeds, but so must any net swap expenses associated with the structure.[25]

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[21] Section 263(g)(1) requires capitalization of interest and carrying charges properly allocable to personal property that is part of a straddle. Section 263(g)(2)(A) defines interest and carrying charges as (i) interest on indebtedness incurred or continued to purchase or carry the personal property, and (ii) all other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property.

[22] Proposed Treasury regulation section 1.263(g)-3(b).

[23] The other two prongs of Proposed Treasury regulation section 1.263(g)-3(b) were utilized in any section 263(g) analysis previously since they were contained in Revenue Procedure 72-18 (1972-1 C.B. 740) which described situations where the phrase "incurred or continued to purchase or carry" was invoked for purposes of section 265(a)(2). Section 265 disallows interest expense on indebtedness incurred or continued to purchase or carry tax-exempt debt. The IRS had ruled privately that authorities under section 265(a)(2) were "useful guidance" in interpreting section 263(g). See Private Letter Ruling 19925044 (February 3, 1999).

[24] Proposed Treasury regulation section 1.263(g)-3(d).

[25] See Proposed Treasury regulation section 1.263(g)-4(c) Ex. 4.

E. Proposed Treasury regulation section 1.263(g)-4 – Rules for allocating amounts that are capitalized pursuant to section 263(g).

Any interest or carrying charges that are forced to be capitalized by section 263(g) must be allocated to the capital account of (or added to the basis of) certain personal property. The Proposed Regulations create a waterfall approach to this allocation. Any interest and carrying charges paid or accrued on indebtedness or other financing issued or continued to purchase or carry personal property that is part of a straddle is allocated in the following order: (i) to personal property that is part of the straddle purchased, directly or indirectly, with the proceeds of the indebtedness or other financing; (ii) to personal property that is part of the straddle and directly or indirectly secures the indebtedness or other financing; or (iii) if all or a portion of such interest and carrying charges are determined by reference to the value or change in value of personal property, to such personal property.[26]

All fees and expenses that are capitalized pursuant to section 263(g) are allocated to the personal property, the acquisition or holding of which resulted in the fees and expenses being paid or incurred.[27] In all cases of capitalized costs under section 263(g) that are not covered by the allocations described above, the Proposed Regulations provide that such costs are to be allocated to personal property that is part of a straddle "in the manner that under all the facts and circumstances is most appropriate."[28]

F. Effective Dates for the Provisions Described in Sections I.C., I.D., and I.E. above

The provisions described in sections I.C., I.D. and I.E. of this memorandum are proposed to apply to interest and carrying charges properly allocable to personal property that are paid, incurred or accrued after the date those provisions are adopted as final regulations by publication in the Federal Register for a straddle established on or after January 17, 2001 (subject to the White House Memorandum, as described above). The importance of this provision is that it may be possible to still enter into certain transactions currently and continue to currently deduct the interest and carrying charges until these provisions are ultimately adopted as final regulations by publication in the Federal Register. In other words, these provisions, as originally drafted in the Proposed Regulations, do not appear to have any retroactive effect even for straddles established on or after January 17, 2001 (or possibly a later date). For instance, it may be possible to still issue a debt instrument after January 17, 2001 (or possibly a later date) that would be part of a straddle under the Proposed Regulations and currently deduct the interest until the date on which these provisions are adopted as final regulations by publication in the Federal Register. However, any such transaction, if entered into after careful consideration of all of the risks and uncertainties surrounding the effective dates of regulations generally and the Proposed Regulations specifically, should contain a provision that permits the transaction to be terminated early (e.g., a tax call provision) upon the occurrence of a change in law.

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[26] Proposed Treasury regulation section 1.263(g)-4(a)(1).
[27] Proposed Treasury regulation section 1.263(g)-4(a)(2).
[28] Proposed Treasury regulation section 1.263(g)-4(a)(3).

II. Proposed Regulations Relating to Qualified Covered Call Options

The straddle rules under section 1092 (and, hence, the capitalization rules of section 263(g) described above) contain a limited exception for the situation where a taxpayer writes a call option while owning the optioned stock (or purchases the stock in connection with the granting of the option), if the call option qualifies as a qualified covered call option (a "QCC").[29] To qualify as a QCC the covered call option must, (i) be exchange traded,[30] (ii) be granted more than 30 days before the day on which the option expires, (iii) not be deep in the money, (iv) not be granted by an options dealer in connection with its activity of dealing in options, and (v) not produce ordinary gain or loss upon sale or exchange.[31] The QCC Regulations provide the additional requirement that the option not have a term of more than one year.[32]

For this purpose an option is treated as deep in the money if the option has a strike price lower than the "lowest qualified benchmark."[33] The term "lowest qualified benchmark" generally means the highest available strike price that is less than the "applicable stock price."[34] The applicable stock price is defined, with respect to any stock on which an option has been granted, as (i) the closing price of the optioned stock on the most recent day on which the stock was traded before the option was granted, or (ii) the opening price of the stock on the day the option was granted if such price is greater than 110% of the price determined under (i) above.[35] Thus, subject to certain limited exceptions, a call option on ABC stock will generally be considered "deep in the money" if the option has a strike price less than the highest available strike price for call options on ABC stock that is less than the closing stock price for ABC on the day previous to the granting of the option.

At the time that the QCC provisions were originally enacted in 1983, a basic assumption was that exchange-traded options would only be available at standardized maturity dates and strike price intervals. This assumption was necessary in defining "deep in the money" as above. However, equity options with flexible terms ("flex options") are now traded on options exchanges, and these options may have strike prices at other than fixed intervals. On June 25, 1998, the Treasury Department published proposed regulations addressing whether strike prices available for flex options affect the definition of QCC for equity options with standardized terms. These regulations, which were finalized on January 21, 2000, provide that the strike prices of

[29] Section 1092(c)(4). Qualified covered call options are also exempt from section 263(g) because section 263(g) only applies to positions in a straddle.

[30] The option must be traded on a national securities exchange that is registered with the SEC or other market that the IRS designates. Section 1092(c)(4)(B)(i).

[31] Section 1092(c)(4)(B).

[32] Proposed Treasury regulation section 1.1092(c)-2.

[33] Section 1092(c)(4)(C).

[34] Section 1092(c)(4)(D).

[35] Section 1092(c)(4)(G). There are three exceptions to the general definition of "lowest qualified benchmark." First, if an option is granted more than 90 days before its expiration date and if the strike price is more than $50, the lowest qualified benchmark is the second highest strike price that is less than the applicable stock price. Second, if the applicable stock price is $25 or less and if, but for this exception, the lowest qualified benchmark would be less than 85% of the applicable stock price, the lowest qualified benchmark is equal to 85% of the applicable stock price. Finally, if the applicable stock price is $150 or less and if, but for this exception, the lowest qualified benchmark would be less than the applicable stock price reduced by $10, the lowest qualified benchmark is equal to the applicable stock price reduced by $10.

flex options are disregarded in determining the lowest qualified benchmark for an option with standardized terms.[36] These regulations did not address whether a flex option was itself eligible for QCC treatment.

The Treasury Department has now proposed regulations that would permit flex options, as well as certain OTC equity options, to qualify for QCC treatment. Under the QCC Regulations, a flex option may be a QCC option provided: (i) it satisfies the general rules for QCC treatment, (ii) the only payments permitted with respect to the option are a single fixed premium paid not later than 5 business days after the day on which the option is granted, and a single fixed strike price stated as a dollar amount that is payable entirely at (or within 5 business days of) exercise, (iii) it is not for a term of longer than one year, and (iv) an equity option with standardized terms must be outstanding for the underlying equity.[37] The "lowest qualified benchmark" with respect to a flex option would be the same as that of a standardized option on the same stock having the same applicable stock price.[38] These rules are proposed to apply to equity options with flexible terms entered into on or after 30 days after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register (subject to the effects, if any, of the White House Memorandum).

The QCC Regulations also provide that certain OTC equity options may be QCC options so that OTC options that are economically similar to flex options may enjoy the same tax treatment. An OTC option will be treated as a QCC option if it meets the same requirements imposed upon flex options and is entered into with a person registered with the SEC as a broker-dealer or alternative trading system.[39] Specifically, in order for an OTC equity option to be eligible for QCC status, in addition to meeting the requirements imposed upon flex options, the option (i) must not be traded on a national securities exchange registered with the SEC, and (ii) must be entered into with a person registered with the SEC as, (a) a broker-dealer under section 15 of the Securities Act of 1934 and the regulations thereunder, or (b) an alternative trading system under 17 CFR 242.300 et seq. These rules have the same proposed effective date as the rules described above relating to flex options.

III. Proposed Regulations Relating to Hedging Transactions

The Hedging Regulations expand the regulatory definition of what constitutes a "hedging transaction" to conform with the current statutory definition provided in section 1221. Understanding and conforming to the Hedging Regulations will soon become important to many more taxpayers since one of the exceptions to the straddle rules and the interest capitalization rules of section 263(g), described above, involves hedging transactions.[40]

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[36] Treasury regulation section 1.1092(c)-1.

[37] Proposed Treasury regulation section 1.1092(c)-1(c)(1). The IRS is studying whether the one-year limitation is necessary.

[38] Proposed Treasury regulation section 1.1092(c)-1(c)(2). Note this determination would disregard strike prices available for other flex options.

[39] Proposed Treasury regulation section 1.1092(c)-3.

[40] See sections 1092(e) and 263(g)(3). While these sections exempt only hedging transactions described in section 1256(e), that section defines "hedging transaction" by reference to section 1221.

Prior to 1994, the IRS classified hedging transactions as capital in nature relying on the U.S. Supreme Court decision in Arkansas Best v. Commissioner. Therefore, the sale of an asset that was acquired as a hedge might produce capital gain or loss while the asset it was hedging might produce ordinary income or loss. Treasury recognized this potential mismatch and, in 1994, adopted Treasury regulation section 1.1221-2, which provided ordinary income treatment for qualifying hedging transactions. The 1994 regulations adopted a definition of "hedging transaction" that incorporated a risk reduction standard. In 1999, Congress amended section 1221 via the Ticket to Work and Work Incentives Improvement Act of 1999 (the "1999 Act"). The 1999 Act defined the term "hedging transaction" by utilizing a more liberal risk management standard. The new proposed Hedging Regulations replace the 1994 version of Treasury regulation section 1.1221-2, conform to the risk management standard adopted by the statute, and generally expand the notion of what constitutes a hedging transaction.

The Hedging Regulations are proposed to be effective for transactions entered into on or after January 18, 2001 (subject to the White House Memorandum). However, the Hedging Regulations provide that the Internal Revenue Service will not challenge any transaction entered into on or after December 17, 1999 and before January 18, 2001, provided that such transaction satisfies the provisions of the Hedging Regulations.

The 1999 Act, among other things, altered the definition of "capital asset" such that gains and losses from hedging transactions (which are clearly identified as such on the day it is acquired, originated, or entered into) will be ordinary income and loss instead of capital.[41] The 1999 Act also provided that supplies of a type regularly consumed by a taxpayer in the ordinary course of the taxpayer's trade or business would not be capital assets.[42] The Act defined a hedging transaction as any transaction entered into in the normal course of a taxpayer's trade or business primarily to (i) manage risk of price changes or currency fluctuations with respect to ordinary property held, or to be held, by the taxpayer, (ii) manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred by the taxpayer, or (iii) manage such other risks as may be prescribed in Treasury regulations.[43]

The Hedging Regulations provide that property that is part of a hedging transaction generally does not constitute a capital asset.[44] Additionally, the Hedging Regulations provide that gain or loss from a short sale or option that is part of a hedging transaction is ordinary.[45] The Hedging Regulations make explicit that gain or loss from a transaction that fails to satisfy the definition of a hedging transaction is not made ordinary merely because (i) the property

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41 Section 1221(a)(7).

42 Section 1221(a)(8).

43 Section 1221(b)(2)(A).

44 Proposed Treasury Regulation section 1.1221-2(a)(1).

45 Proposed Treasury Regulation section 1.1221-2(a)(2). Additionally, Treasury regulation section 1.446-4 provides for special accounting rules for hedging transactions. These regulations generally require that the timing of income, deduction, gain, or loss from a hedging transaction match the timing of income, deduction, gain, or loss from the items being hedged. Treasury regulation section 1.446-4(b).

involved is a surrogate for an ordinary asset, (ii) the transaction serves as insurance against a business risk, or (iii) the transaction serves a hedging function or a similar function or purpose.[46]

The Hedging Regulations restate and refine the statutory definition of a hedging transaction. Thus, a transaction is a hedging transaction if it is entered into (i) in the normal course of a taxpayer's trade or business, (ii) primarily to manage risk and (iii) the risk the transaction is intended to manage is the risk of price or interest rate changes, or of currency fluctuations, with respect to ordinary property, ordinary obligations, borrowings or such other risks as prescribed in regulations.[47] Furthermore, the regulations add that a transaction that is entered into primarily to counteract all or any part of the risk reduction effected by a hedging transaction is itself a hedging transaction.[48]

The above notwithstanding, the regulations provide that certain transactions which are subject to international provisions of the Code are specifically excluded from the scope of the Hedging Regulations. Thus, the Hedging Regulations do not apply to transactions described in section 988, relating to currency gain and loss. Moreover, the definition of a hedging transaction generally does not apply to: (i) interest allocation regulations under section 864(e), (ii) the hedging exceptions to the subpart F rules under 954(c), (iii) the determination of the allocation and source of income for global dealing operation participants, (iv) the determination of whether a risk management function has been conducted related to the activities of a regular securities dealer, and (v) the determination of assets and liabilities of a foreign corporation for interest allocation and branch tax purposes.[49]

The Hedging Regulations specify that a taxpayer's primary motivation in entering into a hedging transaction must be the management of risk. Thus, for instance, the acquisition of an asset for investment is not a hedging transaction even if the asset reduces risk with respect to other assets or liabilities.[50] Under the Hedging Regulations, the acquisition of a debt instrument is not made primarily to reduce risk. Similarly, borrowings generally are not made primarily to reduce risk.[51]

A transaction is entered into in the normal course of a taxpayer's trade or business if it is entered into in furtherance of (including an expansion of) such trade or business.[52] Property is ordinary only if sale or exchange thereof could not produce capital gain or loss regardless of the taxpayer's holding period. An obligation is ordinary if its performance or termination (within the meaning of section 1234A) could not produce capital gain or loss. Whether a hedge of a borrowing is a hedging transaction is determined without reference to the use of the borrowing proceeds.[53]

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[46] Proposed Treasury regulation section 1.1221-2(a)(3).
[47] Proposed Treasury regulation section 1.1221-2(b).
[48] Proposed Treasury regulation section 1.1221-2(c)(1)(v).
[49] See Proposed Treasury regulation section 1.1221-2(a)(4).
[50] Proposed Treasury regulation section 1.1221-2(c)(3).
[51] Proposed Treasury regulation section 1.1221-2(c)(3).
[52] Proposed Treasury regulation section 1.1221-2(c)(4).
[53] Proposed Treasury regulation section 1.1221-2(c)(5)&(6).

Ironically, some of the 1994 regulations' "risk reduction" notion is found in the new Hedging Regulations. For example the Hedging Regulations state that "[a] transaction that is not entered into to reduce a taxpayer's risk does not manage risk."[54] The determination of whether a transaction manages risk depends on the facts and circumstances of the transaction and the taxpayer's business.[55] A transaction generally will be treated as managing risk if it reduces the risk attributable to a particular asset or liability and is reasonably expected to reduce the overall risk of the taxpayer's operations.[56] The Hedging Regulations specifically acknowledge that fixed to floating hedges and certain types of written options may constitute hedging transactions.[57]

The treatment of consolidated group hedging, identification and recordkeeping rules contained in the Hedging Regulations are largely unchanged from the existing regulations. Generally, the Hedging Regulations adopt a single entity approach to consolidated groups pursuant to which the risk of one member of a consolidated group is the risk of the other members, and no intercompany transactions are treated as hedging transactions.[58] However, the Hedging Regulations permit a consolidated group to elect separate entity treatment with respect to its hedging transactions, which election applies to all transactions entered into after the date it comes into effect and may be revoked only with the consent of the Commissioner.[59]

Finally, the Hedging Regulations set out the manner and timing for the identification requirements relating to hedging transactions.[60] The effect of identification, misidentification and failure to identify hedging transactions under the Hedging Regulations remains unchanged from current regulations.[61]

Please feel free to contact any of the following lawyers in our Tax Practice Group for more information regarding any of these new regulations.

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54 Proposed Treasury regulation section 1.1221-2(c)(1)(vii).
55 Proposed Treasury regulation section 1.1221-2(c)(1)(i).
56 Proposed Treasury regulation section 1.1221-2(c)(1)(ii).
57 Proposed Treasury regulation section 1.1221-2(c)(1)(iii)&(iv).
58 Proposed Treasury regulation section 1.1221-2(d)(1).
59 Proposed Treasury regulation section 1.1221-2(d)(2).
60 See generally, Proposed Treasury regulation section 1.1221-2(e). The 1981 Bluebook adds, "[i]t is expected that taxpayers, such as banks or securities dealers, which may conduct thousands of hedging transactions to hedge property held or to be held in their accounts, may identify such accounts as hedged accounts without marking individual items as hedges or hedged property, provide such accounts deal only with ordinary income (or loss) items." Staff of the Joint Committee on Taxation, 97th Cong. 1st Sess., "General Explanation of the Economic Recovery Tax Act of 1981," 279 (Comm. Print 1981).
61 See generally, Proposed Treasury regulation section 1.1221-2(f).