DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Hedging Transactions

This Field Service Advice responds to your memorandum dated January 22, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Company =
Year 1 =
Year 2 =

ISSUES:

1. Whether Company's transactions are part of a hedging transaction within the meaning of Treas. Reg. § 1.1221-2(b), with the result that losses realized on these transactions are ordinary.

2. Whether the requirement of I.R.C. § 446 that a taxpayer's method of accounting must clearly reflect income should be applied to require that certain hedging transactions be accounted for in accordance with the hedge accounting principles of Reg. § 1.446-4.

CONCLUSIONS:

1. Further factual development is necessary to determine whether the transactions at issue qualify as part of a hedging transaction as defined in Reg. § 1.1221-2(b). Nevertheless, to render guidance on the hedge timing issue (Issue 2), we have assumed for purposes of this Field Service Advice that the transactions do qualify as part of a hedging transaction, and thus are excepted from capital loss treatment pursuant to Reg. § 1.1221-2(a)(1).

2. For losses realized on hedging transactions entered into after September 30, 1994, the effective date of Reg. § 1.446-4, assuming that Company intended to hedge the entire term of the underlying debt, Company must spread the hedging losses over the term of the underlying hedged liability. However, Company may currently deduct losses realized on hedging transactions entered into prior to the effective date of Reg. § 1.446-4.

FACTS:

Company is in the business of leasing equipment to end-users. During Year 1 and Year 2, Company securitized the leases it held. Specifically, Company borrowed money from a syndicate of banks as interim financing. Company used these loan proceeds to purchase the equipment from manufacturers, which it then leased to the end-users. Thereafter, Company pooled the leases and sold securities that were collateralized by the pool of leases. The profitability of these securitization transactions depended in large part on the market rate of interest at the time the securities were offered to the public. Prior to the issuance of the collateralized securities, Company was at risk of rising interest rates. To protect itself against this risk, Company entered into hedging transactions to lock in an interest rate.

During Year 2, interest rates decreased, causing Company to realize losses on its hedging transactions. Company deducted this amount as an interest expense for Federal income tax purposes. For book purposes, Company capitalized this amount by allocating it to two securitization pools.

LAW AND ANALYSIS

Treas. Reg. § 1.1221-2 provides rules clarifying the character of hedging gains and losses. Pursuant to Reg. § 1.1221-2(a)(1), property that is part of a hedging transaction is not a capital asset. A hedging transaction is defined to include a transaction that is entered into in the normal course of the taxpayer’s trade or business primarily to reduce risk of interest rate fluctuations with respect to borrowings or ordinary obligations to be incurred by the taxpayer. Reg. § 1.1221-2(b)(2). An obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce capital gain or loss. Reg. § 1.1221-2(c)(5). To obtain ordinary treatment for hedging losses, a taxpayer must satisfy the identification and record keeping requirements set forth in Reg. § 1.1221-2(e).

Hedging losses are deductible from income pursuant to section 165. A hedging loss does not represent an interest expense deductible pursuant to section 163 because the loss is not paid in connection with the use or forbearance of money. See Deputy v. du Pont, 308 U.S. 488 (1940).

The request for Field Service Advice concludes that the transactions at issue qualify as part of a hedging transaction within the meaning of Reg. § 1.1221-2(b). Given the lack of factual development, however, we are unable to conclude as much. As discussed more fully below, further factual development with respect to this issue is necessary. Nevertheless, for purposes of the remainder of this Field Service Advice, we have assumed that the transactions do qualify as part of a hedging transaction within the meaning of Reg. § 1.1221-2(b), and that Company has satisfied the identification and record keeping requirement of Reg. § 1.1221-2(e). As a result, we have assumed that the hedging losses are excepted from capital treatment pursuant to Reg. § 1.1221-2(a)(1).

The Service has issued regulations under section 446 to provide guidance regarding when hedging gains and losses are to be taken into account for tax purposes. These regulations apply to hedging transactions entered into after September 30, 1994. Specifically, Reg. § 1.446-4(b) provides that the method of accounting a taxpayer uses for hedging transactions 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 underlying hedged item.

Treas. Reg. § 1.446-4(e) provides requirements and limitations on the method of accounting for certain hedging transactions, including debt instruments. In the case of an anticipated debt issuance, hedging gains or losses must be accounted for by reference to the terms of the debt instrument and the period to which the hedge relates. Reg. § 1.446-4(e)(4). A hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, generally, is accounted for using constant yield principles. Id. Thus, assuming that a fixed rate or qualified floating rate instrument remains outstanding, the hedging gain or loss is taken into account in the same periods in which it would have been taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. Id.

For example, suppose a taxpayer anticipates issuing debentures paying a fixed rate of interest per annum. In anticipation of this debt issuance, taxpayer sells Treasury securities to reduce the risk that interest rates may increase. If interest rates decline, taxpayer will realize a loss on the hedging transaction. Under the regulations, the taxpayer should account for the hedging loss as if it reduced the issue price of the debt by the amount of the loss. See Reg. § 1.446-4(e)(4).

In this case, assuming that Company intended to hedge the entire term of the underlying debt, Reg. § 1.446-4 requires that losses realized in connection with Company's hedging transactions entered into after September 30, 1994, must be taken into account over the term of the underlying debt instruments using constant yield principles. However, Company may currently deduct losses realized on hedging transactions entered into prior to October 1, 1994, the effective date of Reg. § 1.446-4. Further factual development, as discussed below, will be necessary to correctly determine how Company must spread its hedging losses.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Further factual development is necessary to determine whether the transactions at issue are hedging transactions as defined in Reg. § 1.1221-2(b)(2). The following information is relevant to this determination. (1) How did Company purportedly hedge its interest rate risk? For example, did Company sell Treasury securities or enter into a forward rate agreement? What are the terms of the hedging transactions? (2) Were the hedging transactions comprised of exchange-traded contracts, or over-the-counter positions? Are there any brokerage statements documenting the hedging transactions? (3) Can Company demonstrate that the hedges reduced interest rate risk with respect to the underlying obligations. For example, can Company demonstrate a correlation between changes in the valuation of the purported hedging transaction and the underlying obligations resulting from movement in the interest rate? (4) Were the hedges identified on Company's books and records as hedging transactions for tax purposes? Were the hedges identified for financial accounting purposes? (5) What are the terms of the underlying debt securities?

Further factual development is also necessary to correctly apply the principles set forth in Reg. § 1.446-4. The following information is helpful in applying this regulation. (1) Which hedges were entered into prior October 1, 1994, and which hedges were entered into after September 30, 1994? (2) Does Company accrue deductions on the underlying securities using a constant yield method? Do the securities contain OID, and does Company accrue these deductions consistent with the OID provisions? (3) What are the terms of the securities? Do all of the instruments bear five-year terms? Did Company redeem, renegotiate, retire, exchange, or sell any of the securities prior to the due date of the instruments? Did Company enter into any agreements to extend the due date of the instruments?

(4) Did Company intend to hedge the entire term of the underlying securities?
(5) What is the yield on the underlying securities? What is the issue price of the securities?

Please call if you have any further questions.

By: Carol P. Nachman
CAROL P. NACHMAN
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Financial Institutions & Products Branch

cc: