cutting through complexity™

Hedging

Viva Hammer
KPMG
(202) 412-9798
vhammer@kpmg.com

John Newton
Prudential Financial
John.Newton@prudential.com

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History of Hedging

<u>Original question</u> - are hedges ordinary or capital in character

<u>GCM 17322 (1936)</u> - using futures to hedge against increase in price of T's inputs into manufacturing process AND to hedge against decrease in price of outputs from T's manufacturing process. Derivatives entered into to insure against risks in T's core business considered business insurance and losses are ordinary.

<u>Steward Silk (1947)</u> - T made clothes from silk, anticipated a drop in silk prices because of synthetics, sold silk futures to hedge raw material inventory. In fact, silk prices rose and the hedges had losses. Court allowed ord losses even though risks weren't hedged perfectly.

<u>Corn Products</u> - T hedged against rise in corn prices by buying futures. T had big gains in the futures and argued they weren't valid hedges – only protected against rises in corn prices – not falls.

2nd Circuit, Supreme Court decided they were hedges, ord treatment.

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History of Hedging

Corn Product Doctrine

G/L from sale of property didn't have to come explicitly within 1221 to be treated as ordinary. Property had to be "an integral part" of T's business. Purpose was paramount.

Enactment of 1256(e)

Arkansas Best – Rejected existence of "Corn Products Doctrine"

FNMA

Treasury Regulations: timing and character

Amendment of 1221

More Treasury Regulations: character

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Taxation of Derivatives

Timing/character of income for derivatives varies by contract type

- Timing generally realization based
  - Exceptions:
    - 1256 contracts (regulated futures contracts, forward contracts in actively traded foreign currencies)
    - Nonperiodic payments on swaps
- Character generally capital
  - Exceptions:
    - Income, gain/loss on foreign currency contracts is ordinary
    - Periodic swap payments are ordinary

For insurance companies, capital treatment and timing would not match ordinary taxable income (from premiums, reserve movement)

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Tax Hedge Treatment

- Ordinary gain or loss
- Exception from straddle rules
- Exception from MTM and 60/40 rules for1256 contracts
- Timing rules

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Hedging – Requirements for Tax Hedge

5 Requirements for Hedging Transaction

1. Entered into in the normal course of a trade or business
2. "Primarily"
3. To manage
4. Certain risks
5. From holding ordinary property or incurring certain obligations

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Requirement 1 – Normal Course of Trade, Business

- Broader concept than “ordinary course of trade or business”
- Generally a transaction in the “normal course” is one that furthers a T’s trade or business
- Includes business expansion, other capitalizable activity
- Usually not hard to meet if T is in a trade or business
- May become an issue if the entity entering into the transaction is not an operating company but instead an SPV with no trade or business

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Requirement 2 – "Primarily" to Manage Risk

- Evidentiary inquiry based on objective and subjective factors
- Based on all facts and circumstances
  - Corporate minutes or other records are good evidence of intent
  - Should document rationale for entering into the transaction
- Not a transaction entered into for speculative purposes exclusive of trade or business

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Requirement 3 – Types of Risk

- Types of Risk
  - Interest rate risk
  - Price risk or
  - Currency risk
- Revenue risk and credit risk are not mentioned
- Insurance/Annuity Liability Hedging
  - Guarantees of variable annuity account values or withdrawals may be economically hedged by equity derivatives (e.g., S&P index puts) and interest rate swaps (IIR program)

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Requirement 4 – Manage Risk

- Transaction must manage risk
- Can reduce aggregate risk or specific risk
  - **Aggregate Risk** – T's collective obligations are considered in determining whether or not the transaction reduces risk
    - Risk must concern ordinary property, ordinary obligations, or borrowings
    - Must manage all risk or all but a de minimis amount
  - **Specific Risk** – Transaction may reduce risk of specific asset or liability if it also reduces overall risk

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Requirement 4 – Manage Risk

Transactions that manage risk:

- Written options
- Fixed to floating price hedges
- Interest rate conversions
- Counteracting hedges (transactions designed to counteract an existing hedge)
- Recycled hedges (using the same hedging transaction to hedge a different asset or liability)

Transactions that do not qualify even if they reduce risk:

- Purchase or sale of debt instrument
- Equity security
- Annuity contract

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Requirement 5 – Ordinary Property or Obligations

- Hedging transactions hedge risk regarding ordinary property and ordinary obligations
  - **Ordinary Property** – Property is ordinary "only if a sale or exchange of the property could not produce capital gain or loss *under any circumstances*."
    - Non-inventory supplies are now included
  - **Ordinary Obligation** – An obligation is ordinary if performance or termination of the obligation by T could not produce capital gain or loss.
    - Debt instruments *held by T* are generally capital assets
- Hedges of future property/liabilities/obligations

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Gap Hedging

- Duration Management "Gap hedge"
  - Managing r/ship between assets and liabilities. Insurance companies require asset portfolio duration (i.e., sensitivity to interest rates) to match duration of insurance liabilities, and will hedge (e.g., use interest rate swaps) to obtain match.
- Does gap hedging qualify for tax hedge treatment?
  - Gap hedges relate to both assets and liabilities
  - **Taxpayer position**: insurance company's business is liability driven; gap hedges are intended primarily to manage risks with respect to ordinary liabilities; the fact that they also manage risks with respect to assets is irrelevant
  - **IRS position**: Unclear; preamble to hedging regulations says hedges must be more closely associated with liabilities to qualify

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Which Entity Can Hedge?

A hedging transaction can only manage risks of entity making election

- **Exception** – Consolidated group as one entity with each company treated as division of overall company
  - One member in group can hedge risk of another member
  - But intercompany transaction would not qualify as hedge because risk of overall group not reduced
  - “Separate entity” election possible
    - Each member can only hedge its own risk
    - But, intercompany transaction can qualify as a hedge provided the counterparty marks the contract to market (e.g., section 475 dealer)

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Identification Requirements

- T must clearly identify hedging transaction as such on day acquired, originated or entered into
- T must identify the "hedged item" (e.g., the asset, liability or aggregate risk) within 35 days of entering the hedge
  - Includes identifying transaction that creates risk and type of risk that transaction creates
- T maintains identifications on T's books and records (nothing sent to IRS)
  - Must state identification is for tax purposes – **GAAP hedge ID insufficient**
  - T could designate particular trading account as including only hedging transactions and as such document in tax records; for example, that all interest rate swaps in that account designed to manage borrowing costs

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Character Rules – Taxpayer Identifies Hedge

- If T properly identifies hedge, and the hedging transaction qualifies as hedge, then ordinary income/loss
- If T performs same-day identification but –
  - Other identification requirements are not met, gain is ordinary
  - Transaction is not a tax hedge, character determined according to regular tax rules
- If T identifies as a hedge a transaction that is not a tax hedge, gain determined as if the identification had not been made so long as—
  - The identification was an "inadvertent error"
  - All [similar] transactions in open years are being treated "consistent with the principles of this section" [i.e., not as hedges]
  - PLR suggests inadvertent = "accidental oversight or carelessness" (PLR 2000-52-010)

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Taxpayer Fails to Identify Hedge

- General Rule
  - Transaction not a hedge
- Inadvertent Error Exception
  - T's failure to identify was due to inadvertent error and T treated transactions in all open years similarly
  - Gain or loss from transaction may be treated as ordinary
- Anti-Abuse Rule
  - Generally if no reasonable grounds for treating transaction as other than hedging transaction, gain ordinary, loss capital

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Inadvertent Failure to Identify

- T has burden of demonstrating failure to identify its hedges was both "inadvertent" and "error"
- IRS considers all relevant facts and circumstances
  - T undertook efforts to read tax hedging rules
  - Evidence T specifically intended to identify hedges
  - T's treatment for book and tax of all economic hedges which it has claimed were hedges
  - T's failure to promptly address nonidentified hedges or to establish identification procedures for any transactions that it has previously asserted tax hedges or that were also economic hedges that would qualify as tax hedges "substantially undercuts" T's inadvertent error claim

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Inadvertent Failure to Identify

- T made reasonable and prompt efforts to correct past nonidentifications or timely identify prospective hedges even after it asserts first being aware of the tax hedging rules
- T's statements, other evidence it anticipated having ample capital gains to absorb capital losses would suggest a deliberate decision not to address its lack of tax hedge identification procedures

- "We see no compelling policy justification for reading the inadvertent error rule as an open-ended invitation for T to brush aside establishing hedge identification procedures, knowing that inattention to the rules or even unsound judgment can be fixed on an as needed basis."

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Inadvertent Failure to Identify

Spectrum of Failures:

- Tax Dept ignorant of tax hedging rules
- Tax Dept ignorant of its company's hedging program
- Treasury Dept failure to inform Tax Dept of hedging activity
- Tax Dept identifies some but not all hedges it knows about
- Treasury Dept informs Tax Dept of some but not all hedges it enters into
- Tax Dept accidentally fails to identify some hedges or loses some IDs
- Treasury Dept accidentally fails to inform tax dept of some hedges
- Tax Dept relies on GAAP hedge IDs – some good tax hedges some not
- Tax Dept relies on GAAP hedge IDs – all good tax hedges

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Identification Requirements

Anticipatory Asset Hedges

- Identify the expected dates and amounts of the acquisition

Inventory Hedges

- Identify type or class of inventory that hedge concerns

Debt Hedges

- Hedging existing debt – specify the issue of existing debt being hedged
- Debt to be issued – expected date of issuance, maturity, issue price, interest provisions

Aggregate Risk Hedges

- Describe risk being hedged
- Describe hedging program under which hedging transaction was entered

Counteracting Hedges

- Identify the original hedge and the original hedged item

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Timing Rules

Clear Reflection of Income

- Method must reasonably match the timing of income/deduction/gain/loss from the hedging transaction with the hedged asset
- Taking gains or losses into account when realized may not clearly reflect income
- Concern with cherry picking losses – timing whipsaw

If a transaction meets the requirements for a hedge, hedge accounting applies whether or not the transaction is identified as a hedge (Rev. Rul. 2003-127)

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Timing Rules

- Choice of Timing Rule
  - T can choose any method that clearly reflects income (more than one method may be reasonable)
  - Once T chooses method, it must apply that method consistently
- Record Keeping
  - T must include a sufficient description of accounting method used for each type of hedging transaction in tax books
  - Must show how clear reflection standard is met

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Specific Hedge Timing Rules

- Hedges of debt instruments
  - Coordinate income/deduction from hedge (covers specified periods) with interest or OID on the debt
  - Example – Assume that a fixed-rate debt instrument is outstanding
  - T takes the income/deduction from the hedge into account in the same periods as income/deduction on debt as if adjusted the yield of debt over the term of the hedge

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Hedge Timing Rules and Other Timing Rules

- To the extent hedge timing rules conflict with other regulatory timing rules, hedge timing rules control.
- Hedge timing rules do not apply to
  - A position subject to section 475(a)
  - An integrated debt instrument with election
  - A section 988(d) hedging transaction
- Hedge timing rules do not alter the *character* of the gains/losses from the hedging transaction to match hedged item – they govern timing

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Credit Default Swaps

A credit default swap is a contract in which:

- One party (protection seller) receives up-front or periodic payments from the counterparty (protection buyer)
- In exchange, the protection seller agrees to make payments with respect to a debt instrument – the "reference obligation" – if the issuer of the debt instrument defaults, or if some other "credit event" occurs (generally must pay recovery rate on underlying instrument if issuer defaults).

Uses:

- Hedge bond against issuer credit risk
- Replication – a sell-protection CDS paired with a Treasury note of same maturity replicates a bond on the reference obligation

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Credit Default Swaps

- IRS has sought public comment on treatment (Notice 2004-52), but no guidance has been issued to date
- **Notional principal contract, due to periodic payment element?**
  - If so, credit event payment is presumably contingent nonperiodic payment
  - Preamble to proposed NPC regs say can't use "wait and see" approach
  - Proposed MTM treatment a reasonable method?
- **Option** (i.e., protection seller is writing an option allowing protection buyer to put the reference obligation at par)?
- **Other**?
- Illustrates how a derivative contract may not fit neatly into a particular existing category in the tax rules

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