

TAX SECTION

New York State Bar Association

Report on Proposed and Temporary Regulations
on Character and Timing of
Gains and Losses from Hedging Transactions

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March 4, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Hedging Regulations

Dear Secretary Samuels and Commissioner Richardson:

Enclosed are copies of a Report by the New York State Bar Association Tax Section on the temporary and proposed regulations concerning business hedges.

The Report begins by commending the Treasury Department and the Internal Revenue Service for their "extraordinarily constructive and comprehensive effort to bring order to the legal chaos that has existed with respect to the tax treatment of business hedges." The Report then goes on to make a number of recommendations regarding the proper treatment of both timing and character of gains and losses on hedging transactions.

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Among the recommendations, which are summarized at the beginning of the Report, are that:

(i) hedging treatment should apply to (1) hedges of supplies (either by regulation or legislation), (2) hedges involving non-inventory property whose price tracks the price of inventory, and (3) hedges of certain related party risks, but should not apply to hedges of investment assets;

(ii) a flexible definition of risk reduction should apply in defining an eligible hedge;

(iii) the standards of the regulations should be the exclusive test for qualified hedges for the future, but not for the past;

(iv) in regard to timing, consideration should be given to providing additional guidance applying the matching requirement to under-hedging, hedging with related parties, and hedging the cost of future inventory or the sale price of existing inventory;

(v) global hedges should be dealt with by allowing taxpayers to create one or more "mixed hedge accounts," with gains and losses in each account recognized under one of several alternative approaches described in the Report; and

(vi) a number of clarifications should be made relating to the interaction of the hedging rules and the foreign provisions of the Code.

If it would be helpful, we would be happy to further assist you and your staff in the development of final regulations.

Very truly yours,

Michael L. Schler
Chair

cc: Peter Cobb

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I. INTRODUCTION

In this report (the "Report"),¹ we comment on the temporary and proposed regulations issued by the Treasury Department and the Internal Revenue Service (the "Service") concerning business hedges (the "Hedging Regulations").² Although we offer a number of comments and observations on the Hedging Regulations in this Report, we believe that the Service and Treasury Department are to be commended for an extraordinarily constructive and comprehensive effort to bring order to the legal chaos that has existed with respect to the tax treatment of business hedges.

A. Summary of Conclusions

Our principal recommendations can be summarized as follows:

¹ The principal author of Parts I, II and III of this Report was Dana L. Trier, with substantial assistance from Robert H. Scarborough, Deborah L. Paul and Jeffrey S. Sion. The principal author of Parts IV and V was Robert H. Scarborough, and the principal author of Part VI was Philip R. West. Helpful comments were received from Michael L. Schler, Carolyn J. Lee, Geoffrey R. S. Brown, Richard O. Loengard, Jr., Richard L. Reinhold, Charles M. Morgan, III, David P. Hariton, David E. Watts, Joseph F. McDonald, Stephen B. Land, Erika W. Nijenhuis and Paul R. Wysocki.

² Temp. Reg. §§ 1.1221-2T, 4T; Prop. Reg. §§ 1.446-4, 1.1221-2(c), and 1.1256-1.

- (1) Hedging transaction treatment should be extended to hedges of supplies, either by regulation or legislation.
- (2) It should be clarified that hedging transaction treatment applies to hedges involving assets similar to inventory or other ordinary property even if such assets would not, in fact, constitute ordinary property to the taxpayer, so long as it is reasonably expected that price movements in such property will track price movements of ordinary property held by the taxpayer.
- (3) Hedging transaction treatment should not be extended to hedges of the return from investment assets.
- (4) A flexible approach should be adopted with respect to administration of the reduction of risk standard.
- (5) Hedging transaction treatment should apply to hedges of related party risks entered into with third parties in the consolidated return context and to back-to-back related party hedges in the context of all corporate groups.
- (6) The broad exclusivity rule contained in the Hedging Regulations should not be adopted retroactively.
- (7) The timing rules should be expanded before they are issued in final form to address certain issues

relating to under-hedging, global hedges and hedging transactions with related parties.

- (8) Taxpayers should have broad flexibility to match gain or loss realized from a hedging transaction that "under-hedges" with gain or loss on the corresponding hedged position.
- (9) Gain or loss realized on the disposition of a hedge of the sale price of property held in inventory should be taken into account as an adjustment to gross sales for the tax year in which it is realized regardless of the taxpayer's method of valuing its inventories.
- (10) Gain or loss realized on disposition of a hedge of the cost of property to be acquired and held in inventory should be taken into account as an adjustment to the cost of purchases for the tax year in which it is realized, regardless of the taxpayer's method of valuing its inventories.
- (11) In the case of a hedging transaction entered into by a hedging taxpayer with a related counterparty, the taxpayer should apply the matching requirement in the same way that it would to a hedging transaction with an unrelated counterparty, but the counterparty should defer taking gain or loss into account until the time the taxpayer takes it into account (even if the related parties are not part of the same consolidated group).

- (12) In the case of gain or loss from hedges that cannot be associated with a particular hedged position and that instead offset the net or aggregate risk from a number of hedged positions ("macro-hedges" or "global hedges"), a taxpayer should apply the matching requirement by establishing one or more "mixed hedge accounts," each corresponding to a particular type of risk.
- (13) A taxpayer should be permitted to choose among several alternative approaches, described in detail in the Report, for matching gain and loss from positions in a mixed hedge account.
- (14) If a hedged position is disposed of before the hedge and the hedged position is not inventory, we recommend that the hedge be marked to market at the time of disposition; if the hedged position is inventory, we recommend that gain or loss on the hedge be treated as an adjustment to total sales in the year in which it is realized.
- (15) In the case of an anticipatory hedge relating to a hedged position that the taxpayer does not enter into, we recommend that gain or loss realized on the hedge be treated as ordinary and be taken into account at the same time it would have been had the anticipated hedged position been entered into.
- (16) As to the case of the anticipatory hedge which the taxpayer leaves in place even though the taxpayer does not enter into the hedged position, we believe that the taxpayer should be treated as selling its

hedge and reestablishing its position, and that gain or loss up to such time be ordinary and thereafter capital.

(17) The final Hedging Regulations should prescribe character rules for gain or loss on section 988 transactions to the extent that section 988 does not prescribe such rules.

(18) The final Hedging Regulations should leave undisturbed the calculation of Subpart F income with respect to hedges of property transactions described in section 954(c)(1)(B).

(19) The preamble to the final Hedging Regulations should clarify the carve-out relating to apportionment under section 864(e).

B. Background

1. Types of Hedging Transactions

Two principal types of hedging transactions are the subject of the Hedging Regulations -- hedges of price risk and hedges of interest rate risk.

a. Hedges of Price Risk

Hedges of price risk can be divided into the following categories, based on the type of risk hedged: (1) hedges against the risk that the price of property held by the taxpayer (or to which the taxpayer has a contractual right) will fall (hedges of long positions), (2) hedges against the risk that the price of

property that the taxpayer is obligated to supply will rise (hedges of short positions), and (3) hedges against the risk that the price of property that the taxpayer anticipates purchasing will rise (anticipatory price hedges). A taxpayer may also enter into one or more hedging transactions ("global hedges") to hedge the aggregate or net risk from two or more positions, which may fall into one, two or all three of these categories.

A taxpayer may use one or more of a variety of derivative or other financial products as hedges of price risk. These include long forward or futures contracts, short forward or futures contracts, call options, put options and notional principal contracts with payments based on the prices of commodities or currency (e.g., commodity swaps, commodity caps or currency swaps).

b. Hedges of Interest Rate Risk

Hedges of interest rate risk with respect to debt obligations may be entered with respect to a wide variety of transactions: (1) debt issued by the taxpayer, (2) debt held by the taxpayer, (3) debt that the taxpayer is obligated to issue, (4) debt that the taxpayer is obligated to purchase, (5) debt that the taxpayer anticipates issuing, but is not obligated to issue and (6) debt that the taxpayer anticipates acquiring but is not obligated to buy. These hedging transactions may be designed either to convert a floating rate into a fixed rate (or to put a cap on or floor under a floating rate), or to convert a fixed rate into a floating rate. A taxpayer may also enter into a global interest rate hedge that hedges the aggregate or net risk from a number of different positions. A taxpayer may hedge a debt instrument that bears interest at a rate that is contingent not on market interest rates, such as the prime rate and LIBOR, but

on the change in price or yield from publicly-traded property, including stock, commodities, indexes or currency.

As in the case of hedges of price risk, a taxpayer may use one or more of a variety of derivative or other financial products to hedge interest rate risk. These include long and short forward and futures contracts on Treasury securities, call options and put options on Treasury securities, notional principal contracts with payments based on interest rates (i.e., interest rate swaps, caps and floors), options to enter in to, or to require another party to enter into, such notional principal contracts ("swaptions") and forward rate agreements.

2. Historical Background

Although the techniques for hedging price or interest rate risk have become significantly more sophisticated in recent years, hedging transactions have been the subject of a long history of Service guidance and tax litigation which is instructive as to the issues raised by the approach taken in the Hedging Regulations.³ That history can basically be divided into four parts chronologically: the period prior to the Supreme Court's decision in Corn Products; the period between the Supreme Court's decision in Corn Products and Arkansas Best; the period commencing with the decision in Arkansas Best through mid-1993; and the period in 1993 immediately prior to the promulgation of the Hedging Regulations, including the Tax Court's decision in the Federal National Mortgage Ass'n case and the Revenue Reconciliation Act of 1993.

³ See generally, Kleinbard and Greenberg, "Business Hedges After Arkansas Best," 43 Tax Law Rev. 393 (1988) (hereinafter "Kleinbard and Greenberg").

a. Pre-Corn Products: G.C.M. 17322 and Its
Aftermath

Over fifty years ago, the Service began the process of developing an extra-statutory basis for ordinary treatment of hedging gains and losses. As early as G.C.M. 17322, the Service articulated a business insurance rationale for such treatment.⁴ It is noteworthy, however, that in G.C.M. 17322 the Service took a relatively strict view of the required nexus between the hedge and the transaction that it hedges, applying ordinary treatment under the facts at issue only to hedges against declines in the price of raw materials that have been purchased for future manufacturing needs, and hedges against the price of raw materials that have not been purchased, but as to which the taxpayer has committed to deliver finished goods in excess of its current supply.⁵ The Service's definition of hedge thus appeared to exclude anticipatory hedges.

⁴ Where futures contracts are entered into only to insure against the... risks [of price fluctuations in a cash position] inherent in a taxpayer's business, the hedging operations should be recognized as a legitimate form of business insurance. As such, the cost thereof (which includes losses sustained therein) is an ordinary and necessary expense... Similarly, the proceeds therefrom in the form of gains realized upon hedging transactions are reflected in net income.

G.C.M. 17322, XV-2 C.B. 151, 152 (1936), restated in part in Rev. Rul. 72-179, 1972-1 C.B. 57.

⁵ The G.C.M. states:

Regardless of accounting or inventory methods in use, provisions pertaining to capital gains and losses govern gains or losses on futures contracts which are speculative. Futures contracts representing time hedges against price fluctuation in spot goods are not speculative transactions, though not concurrent with spot transactions. Futures contracts which are not hedges against spot transactions are speculative unless they are hedges against concurrent futures or forward sales or purchases.

Id. at 155.

Much of the litigation that ensued under the business insurance rationale concerned whether the required nexus was present. In particular, in the seminal case of Commissioner v. Farmers & Genners Cotton Oil Co.,⁶ the Fifth Circuit applied the special rules regarding business hedges only to transactions that produced an “even or balanced” position with respect to business hedges. Thus, the basic requirement was that a taxpayer maintain a current economic commitment (either in the form of inventory on hand or a present contractual commitment to deliver future goods), although one court did find that “... it is enough that the offsetting transaction be made while the risk was extant”⁷ and another court applied hedging transaction treatment in a case in which the taxpayer's futures position was closed out after the taxpayer's economic commitment was satisfied but within the same taxable year.⁸

b. Corn Products And Its Aftermath

The Supreme Court's decision in Corn Products,⁹ however, ushered in a much more freewheeling era. The taxpayer in that case was a manufacturer of various products derived from corn which instituted a business practice of entering into futures

⁶ 120 F.2d 772, 774 (5th Cir. 1941).

⁷ Stewart Silk Corp. v. Commissioner, 9 T.C. 174 (1947), acq., 1948-2 C.B. 3.

⁸ Fulton Bag & Cotton Mills v. commissioner, 22 T.C. 1044 (1954), acq., 1955-1 C.B. 6.

⁹ Corn Products Ref. Co. v. Commissioner, 350 U.S. 46 (1956).

transactions in order to insulate itself against fluctuations in corn prices.

Although the taxpayer's transactions were arguably not true "balanced hedges" because the taxpayer was not under a fixed commitment to sell corn products at fixed prices, the Second Circuit,¹⁰ nevertheless, held that gain or loss thereon should be treated as ordinary because the taxpayer's purchases were consummated in order to obtain business protection and ensure the profitable conduct of its business. The Second Circuit's rationale for upholding the Tax Court's decision was a seemingly narrow one, based on the statutory language defining capital assets:

In the hedge . . . the property is used in such a manner as to come within the exclusions, for it is a part of the inventory purchase system which is utilized solely for the purpose of stabilizing inventory cost.¹¹

The Supreme Court's approach was not, however, so limited: in confirming the decisions below, it expressed the extremely broad view that "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gains or loss."¹²

¹⁰ Corn Products Ref. Co. v. Commissioner, 215 F.2d 513, 515 (2d Cir. 1954).

¹¹ Id. at 516 (emphasis supplied).

¹² 350 U.S. at 52.

Over the years, this expansive approach became the basis for ordinary treatment of such diverse assets as baseball player contracts held by a minor league baseball team¹³ and stock of a subsidiary held to ensure supply.¹⁴ In the words of two commentators, “. . . the application . . . to commercial hedging transactions was reduced to a trivially easy example of a broad reaching principle of tax law.”¹⁵ While the Service valiantly attempted to constrain the application of Corn Products principles -- by, for example, asserting a “substantial investment motive” test with respect to corporate stock¹⁶ -- it generally assumed a legal framework in which “. . . ordinary income may be produced by the sale or exchange of property which does not fit within the five exceptions of section 1221 but fits within the judicial exceptions to capital gains status, including Corn Products Refining.”¹⁷ As evidenced by the hedging exception contained in section 1256,¹⁸ Congress similarly assumed the application of such principles to at least certain hedging transactions.

¹³ Hollywood Baseball Ass'n. v. Commissioner, 423 F.2d 494 (9th cir. 1970), cert, den., 400 U.S. 848 (1970).

¹⁴ Schlumberger Technology Corp. v. U.S., 443 F.2d 1115 (5th Cir. 1971).

¹⁵ Kleinbard and Greenberg at 411.

¹⁶ Rev. Rul. 78-94, 1978-1 C.B. 58.

¹⁷ G.C.M. 38178 (NOV. 27, 1979).

¹⁸ Section 1256(e).

c. Arkansas Best and Its Ramifications

This assumption was upset by the Supreme Court's decision in Arkansas Best Corp. v. Commissioner,¹⁹ not so much as a result of the decision itself, but once again because of the Court's language used to support that decision. Arkansas Best was a diversified holding company that acquired stock in a national bank in a series of separate purchases. After selling the bulk of its stock, the holding company took an ordinary loss on its return.

The Tax Court sustained the taxpayer's ordinary loss deduction with respect to the purchases of stock by the taxpayer after the original purchase, finding that these purchases were designed to preserve the taxpayer's business reputation.²⁰ The Court of Appeals for the Eight Circuit reversed, in an opinion that came perilously close to questioning the Supreme Court's decision in Corn Products.²¹

¹⁹ 485 U.S. 212 (1988).

²⁰ Arkansas Best Corp. v. Commissioner, 83 T.C. 640 (1984).

²¹ The Court stated:

It seems to us that one of the last places where the legal system deliberately should foster subjectivity and uncertainty is the tax code. Corn Products and its progeny, which we respectfully view as misbegotten, have done precisely that, leading to increased recourse to the administrative and judicial processes to resolve conflicting contentions about taxpayers' motivations in purchasing capital stock. Congress could have written section 1221 to incorporate some sort of exception regarding capital stock . . . but it did not do so. We believe that the judiciary lacks the authority to create exceptions to section 1221 that Congress did not choose to make. Arkansas Best Corp. v. Commissioner, 850 F.2d 215, 221 (8th Cir. 1986) (emphasis supplied).

In upholding the Eight Circuit's decision in Arkansas Best, the Supreme Court took up the invitation to narrow Corn Products:

We conclude that Corn Products is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of § 1221. Arkansas Best, which is not a dealer in securities, has never suggested that the Bank falls within the inventory exclusion. Corn Products thus has no application to this case.²²

While it was clear that the Supreme Court's decision in Arkansas Best had drastically affected the treatment of corporate stock, it was unclear exactly how much impact it had with respect to other types of transactions. As interpreted initially by the Service,²³ the Supreme Court's opinion in Arkansas Best could mean that only hedges which are directly within the inventory exception were subject to ordinary treatment. Most thoughtful observers believed that, at a minimum, the treatment of liability

²² Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 222 (1988) (footnote omitted).

²³ See Letter of Stuart L. Brown, Associate Chief Counsel (Domestic), Internal Revenue Service, concerning tax status of Options Pilot Program put options with respect to agricultural products: "As interpreted by the Supreme Court in the Arkansas Best case, section 1221 makes all assets capital assets unless they fall within an explicit provision that makes them ordinary. There is a provision that gives ordinary character to inventory (like a farmer's crop) but not one that explicitly covers futures positions with respect to inventory."

hedges was cast in some doubt because of the Court's emphasis on coming within the literal language of section 1221.²⁴

d. The FNMA Decision and the 1993 Budget Act

Concerns that the Supreme Court's decision in Arkansas Best would be so narrowly read were alleviated to some extent by the Tax Court's decision in Federal National Mortgage Assn. v. Commissioner,²⁵ the first significant case to test the scope of Arkansas Best. During the years in question, Federal National Mortgage Association ("FNMA") entered into hedging transactions to limit the risk that interest rates would rise, both with respect to anticipated purchases of mortgages under commitments granted by FNMA to mortgage lenders and with respect to some of its anticipated issuances of debentures. Because interest rates fell during the period in question, FNMA realized losses on most of the interest rate futures contracts, options on interest rate futures contracts and short sales of Treasury securities that it used as hedges. In seeking to deny the taxpayer's treatment of these transactions as giving rise to ordinary deductions, the Service asserted the view that, under Arkansas Best, a hedge gives rise to ordinary gain or loss only if the hedged position itself is property that comes within one of the exceptions of section 1221.²⁶

²⁴ Kleinbard and Greenberg at 432-440.

²⁵ 100 T.C. 541 (1993).

²⁶ Federal National Mortgage Association v. Commissioner, 100 T.C. 541, 575 (1993).

This reading of the scope of Arkansas Best was rejected by the Tax Court, in a fully reviewed decision, holding that “to the extent that its mortgages fall within one of the statutory exceptions to capital asset treatment, petitioner may rely on the general reasoning of Arkansas Best to obtain ordinary treatment for the hedges relating to these assets”.²⁷ Noting that according to a 1977 settlement agreement FNMA's mortgages produced ordinary income and loss and citing Burbank Liquidating,²⁸ the Tax Court held that the mortgages of FNMA fell within the exception to capital treatment contained in section 1221(4) (relating to “accounts or notes receivable acquired in the ordinary course of trade or business for services rendered . . .”), and that, therefore, losses on hedges thereof should be accorded ordinary treatment.²⁹ In addition, the Tax Court rejected the Service's positions that it is necessary for ordinary treatment that the hedge must involve the same property as the asset being hedged, and that only hedges of long positions can qualify.³⁰ Finally, noting the inconsistency with section 1256(e), the Tax Court dismissed the Service's argument that a hedge cannot pertain to liabilities.³¹

²⁷ Id. at 577.

²⁸ 39 T.C. 999, 1009 (1963), aff'd in part, reversed in part 335 F.2d 125 (9th Cir. 1964).

²⁹ Federal National Mortgage Assn. v. Commissioner, 100 T.C. 541, 577 (1993).

³⁰ Id. at 576.

³¹ Id. at 577.

While limited in its applicability to other types of taxpayers because of the unique business of FNMA, the Tax Court's decision apparently stimulated a review by the Service of its position with respect to the effect of Arkansas Best on the treatment of hedging transactions. Moreover, in the Conference Report accompanying the Revenue Reconciliation Act of 1993, Congress instructed the Treasury Department to review the law of business hedges.³²

3. Policy Considerations

Against this historical backdrop, the formulation of a comprehensive approach to business hedges required the Service and Treasury Department to address three interrelated policy considerations. The first was to determine the type of transaction subject to hedging treatment: i.e. to formulate a rule as to the circumstances in which a business hedge should be viewed as sufficiently connected to the business activities of the taxpayer to permit ordinary loss treatment on the hedge. On the one hand, it clearly makes sense, at some level, for gain or loss on a hedging transaction to be viewed as ordinary if it relates directly to an ordinary income producing activity, because either it affects the cost of that activity or the gross proceeds derived from the activity. On the other hand, the hedging activity can, in some circumstances, have some element of "speculative investment" character, with capital gain or loss treatment thus potentially being appropriate. Dating back to at least G.C.M. 17322, the Service has struggled with the question how to draw the line.

³² H. Conf. Rep. No. 103-213 (August 4, 1993), Cong. 1st Sess. 616 (Conference Report).

The second policy consideration was the avoidance of whipsaw to the government. Of course, the whipsaw problem arose in large part out of the legal imprecision as to the transactions that should be entitled to hedging treatment. This problem for the government -- which reached its height during the period between the Corn Products and Arkansas Best decisions -- was most evident in the corporate stock cases, in which nobody really believed that the taxpayers would treat gains from the disposition of the stock as ordinary income. This concern was, at one time, even addressed legislatively by a still-born proposal to require taxpayers to identify their proposed treatment of an asset,³³ an approach which to a limited extent found its way into the Code in the hedging exception in section 1256.

The third and more subtle policy issue was that of proper timing of the recognition of hedging gains and losses, a consideration which became increasingly apparent to policymakers as they sought to address the proper treatment of hedging transactions in the aftermath of Arkansas Best. The role of the capital loss limitation in preventing "cherry-picking" has received greater attention by commentators in recent years.³⁴ Moreover, as noted by the Treasury Department,³⁵ the exponential growth of hedging products has increased the potential for timing abuses. As analysis of the legal treatment of hedging proceeded, it thus became obvious that any proposal affecting the treatment

³³ H.R. 10902, 94th Cong., 2d Sess., reprinted in H.R. Rep. No. 1360, 94th Cong., 2d Sess.

³⁴ Ginsburg, "Income Tax Complexity: Capital Gains and Loss Issues," Proceedings of the Invitational Conference on Income Tax Complexity, Reston, Virginia 1990; Scarborough, "Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax," Tax Law Review (forthcoming) (hereinafter "Scarborough").

³⁵ Letter dated October 18, 1993 of Secretary of the Treasury Lloyd Bentsen to Hon. Dan Rostenkowski, Hon. Daniel Patrick Moynihan, Congressmen William Archer and Senator Robert Packwood (hereinafter the "Bentsen Letter").

of losses as capital necessarily implicates timing considerations.

C. Overview of Hedging Regulations

The Hedging Regulations are responsive to each of these three general policy considerations. At the heart of the Hedging Regulations is the attempt of the Service and Treasury Department to define a “hedging transaction” that may be given ordinary treatment. The Hedging Regulations, in general, adopt the language of section 1256(e)(2) for this purpose. Thus, to qualify as a hedging transaction, a transaction must be entered into in the normal course of the taxpayer's trade or business primarily (i) to reduce the risk of price changes or currency fluctuations with respect to “ordinary property” that is held or to be held by the taxpayer, or (ii) to reduce the 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.³⁶ In general terms, property is “ordinary property” if a sale or exchange of the property by the taxpayer could not produce capital gain or loss, regardless of the holding period.³⁷ An obligation is an ordinary obligation “if performance or termination of the obligation by the taxpayer could not produce capital gain or loss.”³⁸ Importantly, the Hedging Regulations provide that a hedge of any borrowing can qualify as a hedging transaction, without regard to whether gain or loss on the retirement of the liability would be ordinary.³⁹

³⁶ Temp. Reg. § 1.1221-2T(b) .

³⁷ Temp. Reg. § 1.1221-2T(b)(2).

³⁸ Id. (emphasis supplied).

³⁹ By contrast, under section 1256, hedging transaction treatment with respect to borrowings is limited to cases in which “gain or loss on such transactions is treated as ordinary gain or loss.” Section

The Hedging Regulations permit so-called “global hedges” reducing an aggregate risk of interest rate, price changes, and/or currency fluctuations, but “only if all of the risk or all but a de minimis amount” of the risk is with respect to ordinary property or ordinary obligations and borrowing.⁴⁰ Moreover, as stated in the Preamble to the Hedging Regulations, because a hedging transaction must reduce the “taxpayer's” risk, the regulations do not apply with respect to “split hedges”, i.e., hedges of a related party's risk.⁴¹

In addition to defining a hedging transaction relatively narrowly by reference to the nature of the property hedged, the Hedging Regulations address the whipsaw problem in two ways. First, a taxpayer entering into a hedging transaction must identify the transaction as such according to rules contained in the regulations.⁴² Generally, if a transaction is identified as a hedging transaction, the identification is binding with respect to gain, whether or not all the requirements for hedging transaction treatment are satisfied.⁴³ If, however, the substantive requirements for hedging treatment are not met, the character of loss will be determined under general principles “without reference to whether the transaction serves a hedging

1256(e)(2)(B). Commentators have disagreed on the effect of this limitation on liability hedges. Compare Kleinbard and Greenberg at 423 with Shashy, “The Long and Short of Straddles as a Tax Savings Device: Hew Law,” 40 N.Y.U. Tax Institute § 17, at 17-13, n. 32 (1982). In this connection, it is noteworthy that the definition of “ordinary property” in the Hedging Regulations is arguably narrower than the property to which section 1256(e) applies because it applies to property that only can produce ordinary gain or loss.

⁴⁰ Temp. Reg. § 1.1221-2T(b)(3) (emphasis supplied).

⁴¹ See Fed. Reg., Vol. 58, No. 201, 54037 (Oct. 20, 1993) (hereinafter the “Preamble”).

⁴² Temp. Reg. § 1.1221-2T(c).

⁴³ Temp. Reg. § 1.1221-2T(d)(1).

function.”⁴⁴ Somewhat surprisingly, if a hedging transaction is not identified, unless certain rules relating to inadvertent error apply,⁴⁵ gain there-from will be ordinary only if the taxpayer had no reasonable basis for not treating the transaction as a hedge.⁴⁶

Second, and more broadly, an exclusivity rule is established: “gain or loss on property, a short sale, or an option is ordinary on the grounds that the property, short sale or hedging transaction serves a hedging function only if the property, short sale or option is part of a hedging transaction as defined. . . .”⁴⁷ Thus, according to the Preamble, “if a transaction falls outside the regulations, gain or loss is not made ordinary by the fact that property is a 'surrogate' for a noncapital asset or that the transaction serves as 'insurance' against a business risk.”⁴⁸

Under the general effective date, the substantive rules apply to all open years.⁴⁹ The identification requirements, by contrast, apply to transactions entered into on or after January 1, 1994, and to prior transactions that remain in existence on March 31, 1994.⁵⁰

Finally, for the first time, the Service has provided, in proposed form, regulations concerning the timing of income or

⁴⁴ Id.

⁴⁵ Temp. Reg. § 1.1221-2T(d)(2)(ii).

⁴⁶ Temp. Reg. § 1.1221-2T(d)(2)(i) and (iii).

⁴⁷ Temp. Reg. § 1.1221-2T(a)(3).

⁴⁸ Preamble at 54038.

⁴⁹ Id. at 54039.

⁵⁰ Temp. Reg. § 1.1221-2T(5) and (6).

loss from hedges ("proposed timing regulations"). These provisions establish the general standard that "... to clearly reflect income, the method used must reasonably match the timing of income, deduction, gain or loss from the items being hedged."⁵¹ The proposed timing regulations generally grant "substantial latitude in the selection of a method of accounting for hedges."⁵² Aside from the provisions of standards relating to inventories⁵³ and certain other limited matters,⁵⁴ however, the proposed timing regulations provide relatively little specific guidance.

Importantly, the limited scope of the timing regulations is emphasized:

The rules of this section govern the timing of income on hedging transactions but do not affect the type or character of gain, loss, income or expense produced by the transaction.⁵⁵

D. Coverage of Remainder of Report

The remainder of the Report will be divided into five parts:

⁵¹ Prop. Reg. § 1.446-4(b).

⁵² Preamble at 54078; Prop. Reg. § 1.446-4(c).

⁵³ Prop. Reg. § 1.446-4 (e)(2).

⁵⁴ Prop. Reg. § 1.446-4(e)(1) (items marked to market); Prop. Reg. § 1.446-4(e)(3) (debt instruments); Prop. Reg. § 1.446-4(e)(4) (notional principal amount contracts); and Prop. Reg. § 1.446-4(e)(5) (disposition of certain assets and liabilities).

⁵⁵ Prop. Reg. § 1.446-4(f).

- (a) A review of the issues raised with respect to the definition of hedging transactions;
- (b) Consideration of the exclusivity rule;
- (c) An analysis of the timing rules;
- (d) An analysis of the effect of a change in the status of a hedge; and
- (e) A discussion of the foreign tax aspects of the Hedging Regulations.

II. THE SCOPE OF HEDGING TRANSACTION

The decision to draw the definition of hedging transaction directly from section 1256(e) is an understandable one because section 1256(e) represented a clear Congressional understanding of certain activities for which hedging treatment is appropriate. For that reason, it would be relatively difficult to argue that the Service has no authority either to permit or mandate ordinary treatment for transactions within the definition of hedging transaction contained in the Hedging Regulations. The weight placed on the section 1256 hedging exception by the Tax Court's FNMA decision⁵⁶ increases the strength of the Service's position. Most of the significant policy and interpretative

⁵⁶ In that case, the Tax Court stated:

We note that respondent's position is inconsistent with section 1256(e) in which hedging transactions are specifically excepted from being marked to market under section 1256(a).... It strikes this Court as odd that Congress would provide an exception to the mark to market regime that would effectively serve no purpose, if, as respondent claims, property serving to hedge a borrowing were not excepted under section 1221.

FNMA V. Commissioner, 100 T.C. 541, 577 (1993).

issues posed by the Hedging Regulations, however, relate to this use of the section 1256 language.

The approach taken by the Hedging Regulations to defining the limits of hedging transaction treatment is interesting when placed in historic perspective. In this regard, the most notable aspect of the regulations is that the approach taken to defining the scope of hedging treatment is relatively strict as to the type of the property that may be the subject of the hedge, but relatively liberal as to the required nexus. On the one hand, property that would likely have been viewed as appropriately the subject of or part of a hedge historically would not, apparently, qualify under the Hedging Regulations. On the other hand, the Hedging Regulations permit anticipatory and (within limits) global hedges even if the hedge is not “balanced” or the risk being hedged does not entail a current economic commitment.⁵⁷ While the approach taken by the Hedging Regulations has the salutary effects of establishing with certainty the authority for the regulations, constraining the grossest excesses of the post-Corn Products era and covering “most ordinary business hedges” as asserted in the Preamble, the policy results reached in a number of cases as a result of this approach may reasonably be questioned.

⁵⁷ Temp. Reg. § 1.1221-2T(b)(1) and (3).

As discussed further below, we believe that the transactions covered by the Hedging Regulations should be expanded. To a significant extent, comprehensive timing rules permit such expansion without undue compromise of the government's interests. In addition, we suggest other steps that will permit such a liberalization of treatment.

In this part of the Report, we will address three particular aspects of the substantive scope of the definition of hedging transaction: (i) the limitation of hedging transaction treatment to hedges of certain property, i.e., ordinary property; (ii) the reduction of risk requirement; and (iii) the treatment of hedges of related party risks. Our recommendations with respect to these matters are summarized in subparagraphs 1 through 5 of Part I.A. of this Report.

A. Property Subject of Hedging Transaction

Perhaps the most controversial aspect of the Hedging Regulations is the limitation of the subject of hedging to ordinary property, ordinary obligations and borrowings, particularly the limitation relating to ordinary property. As noted above, a hedging transaction is defined to include, inter alia, a transaction that a taxpayer enters into to reduce the risk of price changes or currency fluctuations with respect to "ordinary property." Ordinary property is defined, in turn, as property that could not produce capital gain or loss. According to the Preamble, the "Service believes that it is inappropriate ... to have a loss on a hedge treated as ordinary when gain on the item or items being hedged could be treated as capital gain."⁵⁸

⁵⁸ Preamble at 54039.

This aspect of the Hedging Regulations gives rise to issues with respect to at least three types of hedges: (i) hedges of supplies; (ii) hedges involving property that is not identical to ordinary property held by the taxpayer; and (iii) hedges of the return from investment assets.

1. Supply Hedges

Because of the emphasis on the property being hedged, one effect of the Hedging Regulations is to deny hedging transaction treatment even though the hedge ultimately relates to a business activity (such as the provision of services) that clearly produces ordinary income and the hedged asset likely will, in one way or another, be consumed in that activity. The case that has received the most public focus is the airplane fuel supply case. Assuming (as does the Treasury Department in its letter to Congress relating to the Hedging Regulations)⁵⁹ that gain or loss on the sale of the fuel by the airline could be capital, hedging treatment would be denied under the Hedging Regulations with respect to hedges of airplane fuel even though actual consumption of that fuel by the airline would give rise to an ordinary deduction.

One suggested approach to the case of the airplane fuel and similar examples has been to change the standard applicable to supplies from one emphasizing the character of the sale of the hedged item to the treatment of the item as a cost in the business activity of the taxpayer. Thus, some groups commenting on the Hedging Regulations have argued that the hedging gain or loss should be viewed as a purchase price or cost adjustment to

⁵⁹ Bentsen Letter.

an asset consumed in the business and thus subject to the same treatment as the use or consumption of the hedged asset.⁶⁰

At the outset, the potential breadth of the rationale for such a rule should be noted. In concept, it would appear to apply to hedges of section 1231 assets, for example, as well as to supplies like fuel. Under the Hedging Regulations, hedging transaction treatment would be denied with respect to hedges of section 1231 assets because the sale thereof can give rise to capital gain. Conceptually, however, machinery, like fuel, is consumed in the process of providing goods or services; and, in the normal course of events, this "consumption" of the machinery gives rise to ordinary deductions (in the form of depreciation). If hedging treatment were applied to section 1231 assets, the government would arguably not be fully protected.

Under the proposed timing regulations, gain from a hedge of a section 1231 asset would presumably reduce basis and thus could result in increased capital gain on sale. In contrast, hedging losses would presumably be capitalized and recovered in the same manner as the section 1231 asset (through the recovery of costs by deductions taken concurrently with depreciation); but because the Hedging Regulations do not affect the character on the gain of the hedged property, taxpayers could achieve capital gain treatment on sale, without application of statutory recapture to the ordinary deductions already taken for hedging costs. Thus, while, ironically, a legal argument can be made that hedging transaction treatment could be applicable to hedges of section 1231 assets because such assets generally come within subparagraph (2) of section 1221, hedging treatment for section

⁶⁰ See, e.g., Arkansas Best Coalition, December 20, 1993 Letter to the Internal Revenue Service.

1231 assets would appear to be problematic from a policy point of view.⁶¹

Irrespective of the treatment of section 1231 assets, however, airplane fuel supply or other supply cases are sympathetic cases for ordinary gain or loss treatment. In a very real sense, when the fuel is consumed in the business, hedging costs of that fuel are properly viewed as a cost of the ordinary income production, inseparable from other costs of the provisions of the transportation services. In concept at least, even though section 1221 itself is not implicated, it is difficult to distinguish the supply of fuel to an airline from asset purchases that are an "integral part of an inventory purchase system."⁶²

Moreover, it can be argued that extending hedging transaction treatment to supply hedges would actually decrease the practical potential for whipsaw of the government. The exclusion of such hedges from hedging transaction treatment permits gains on disposition of the hedge itself to be treated as capital, while taking delivery there-under can result in deductions against ordinary income as the supply is consumed. A taxpayer that has entered into a derivative contract to hedge against the risk that the price of a supply will rise can choose

⁶¹ It must be acknowledged, however, that the effect of not extending hedging transaction treatment to section 1231 assets is to make the often difficult question of when something is included in inventory even more critical. See, e.g., the sale or lease cases such as Recordak Corporation v. U.S., 325 F.2d 460 (Ct. Cl. 1963) and the line pack cases such as Trans-western Pipeline Company v. U.S., 639 F.2d 679 (Ct. Cl. 1980).

⁶² It should also be noted in this connection that certain supplies are not included in inventory, even though the consumption of such supplies gives rise to a cost included in inventory under the uniform capitalization rules. See Reg. §1-263A-1T(b)(2)(iii)(F) (capitalization of indirect supply costs). It would appear that such supplies, because not inventory, could not be the subject of a qualified hedging transaction. Thus, literally, under the Hedging Regulations, a manufacturer could not hedge fuel for a manufacturing plant. Because these costs are clearly part of an inventory system, the rationality of this result can be questioned.

to sell the contract if prices rise but not if prices fall. Exclusion of hedges of non-inventory supplies from the definition of hedging transactions thus appears to permit taxpayer electivity with respect to character.

To illustrate, assume that an airline believes that it has a future need for x amount of jet fuel that currently has a price of 100. In order to mitigate its price risk with respect to this supply requirement, it enters into a forward contract that both entitles and obligates it to buy the x quantity of jet fuel for 100 at a designated point in the future. Assume that the price of jet fuel rises to 125. The airline can choose to sell the contract, generating 25 of income which will be treated as capital gain, and purchase on the market the x quantity of fuel for 125, which, when used in the business, will generate 125 of ordinary deductions. The taxpayer would have fully used x amount of the fuel in its business, and the real cost to the taxpayer airline of such use would be 100. Rather than simply 100 of ordinary deductions, however, it would have 125 of ordinary deductions and 25 of capital gain. If, instead, the price of x quantity of jet fuel fell to 75, the airline would presumably choose to perform under the contract and take delivery of the fuel, generating ordinary deductions in the amount of 100 when the fuel is used in its business.

Thus, leaving aside the question of authority, it could be argued that, in this common situation, the government has a strong interest in a more expansive definition of hedging transaction.⁶³ The limitation on hedging transaction treatment in this respect may also be questioned because some taxpayers could effectively achieve ordinary treatment by other means. Thus, for example, it appears that by entering into a commodity swap transaction, a taxpayer could price hedge with respect to supply and still achieve ordinary deductions. Some taxpayers could also enter into fixed price contracts with a supplier who would, in turn, buy a qualified hedge with respect to the fuel (which would constitute inventory to it) and pass the hedge costs on the taxpayer: both sides to this transaction would, in effect, be able to achieve ordinary gain or loss treatment with respect to the hedging costs. Finally, to achieve such treatment, the taxpayer could, at greater inconvenience, utilize a subsidiary for which the fuel would be inventory to achieve such treatment, at least under current law; in that case, in the context of an affiliated group filing consolidated returns, ordinary income or loss would result to the supplying subsidiary and the airline subsidiary would receive an ordinary deduction as the fuel is purchased and consumed.

While these considerations militate in favor of extending hedging transaction treatment, even if hedging treatment is so extended there will remain the possibility of

⁶³ This point was made by the Supreme Court itself in Corn Products:

To hold otherwise [*i.e.*, to apply capital gain treatment to the hedges at issue] would permit those engaged in hedging transactions to transmute ordinary income into capital gain at will. The hedger may either sell the future and purchase in the spot market or take delivery under the future contract itself. But if the sale of the future created a capital transaction while delivery of the commodity under the same future did not, a loophole in the statute would be created and the purpose of Congress frustrated. Corn Products Ref. Co. v. Commissioner, 350 U.S. 46, 53-54 (1955).

whipsawing the government. Assume that, in the airline fuel example described above, the price of the x fuel rose to 125 after the airline entered into the hedging contract. The airline might take delivery of the x fuel by paying 100 and selling it for 125, generating a capital gain of 25. It then could take the 125 it has received for the fuel and buy x fuel for 125 on the spot market and use it in its business, generating 125 of ordinary deductions. In this case, the taxpayer would again have a net 100 of real cost, but would have 125 of ordinary deductions and 25 of capital gain. If, however, the price of fuel fell to 75, the taxpayer could (if hedging treatment applied) achieve ordinary loss treatment either by selling the contract or taking delivery there-under. Although many taxpayers will not engage in the extensive activity necessary to produce capital gain in this example, the potential for whipsaw of the government by motivated taxpayers would continue to be present.

A case in which the approach taken under the Hedging Regulations might legitimately be viewed as more protective of the government's interests than would be the case if hedging treatment were extended is that in which the taxpayer is in part engaging in a speculative activity from the inception of the transaction. Assume, for example, that the airline described above perceived that it has a real need for only $1/2 x$ of fuel. Assume further, however, that it enters into two forward contracts for a total amount of x fuel at a price of 100 when prices are 100, with each forward contract being for $1/2 x$ fuel deliverable at the date in the future that the airline needs $1/2 x$ of fuel. In this case, then, the taxpayer would, from the beginning, effectively be speculating on $1/2 x$ of fuel.

Assume the price of fuel rose to 125 by the time of delivery. If hedging treatment applied, the taxpayer could take

delivery under both contracts for 50 each, sell one half for a gain of 12.5 taxed at capital gain rates, and take ordinary deductions of 50 with respect to the $1/2 \times$ it actually uses.

Considered only from the perspective of this example in which the price of fuel has risen, it may be questioned whether there is really a substantial tax policy problem. If the taxpayer in question had simply bought (and stored) x amount of fuel for 100 for both future use and speculation, it would have had the same result: ordinary deductions of 50 with respect to the fuel actually used in the business, and capital gain of 12.5 ($62.5 - 50$) on the sale of the fuel that was, in effect, the subject of speculation.

But if prices fell to 75, it could take delivery of the fuel under one forward contract for 50 to use in its business and generate ordinary deductions of 50, while selling or otherwise disposing of the other contract at a loss for 12.5, taking an additional ordinary deduction of 12.5 for that amount if hedging transaction treatment applied. In this case, then, the taxpayer would be in a better position than if it had simply taken early delivery of x fuel: in effect, it has the option of taking ordinary deductions with respect to the speculative portion of its fuel purchase activity.

Thus, as to a speculative activity (i.e., one of the two futures contracts), the taxpayer would be in a “heads I win tails you lose” position vis-à-vis the government if it were able to sustain hedging transaction treatment: it would get capital gains treatment if it has a gain, and ordinary treatment if it has a loss as to both the speculative and business activity. This has been precisely the concern of the government since at least G.C.M. 17322, a concern which initially led the Service to take a strict view of the required nexus between the hedge and the income producing activity by, for example, limiting hedging treatment to “balanced” hedges.

Again, the analogy of section 1231 assets is instructive. Under our current system, if an asset such as machinery is used in a trade of business, capital gain/ordinary loss treatment is available upon its disposition, subject to recapture of certain depreciation deductions actually already taken. The fuel supply would be analogous to a section 1231 asset in this respect if hedging transaction treatment were extended to such hedges. Given the modest policy rationale for section 1231 treatment,⁶⁴ however, it may be questioned whether something analogous to section 1231 treatment should, in fact, be extended to supply hedges.

In addressing the policy issues raised by these cases, the limits that the government has placed on its protection in the Hedging Regulations should be emphasized. Although the Service has required, through the identification rules,

⁶⁴ The predecessor of section 1231 was enacted in 1942 to address a very specific problem, the treatment of involuntary profits on shipping vessels destroyed by enemy action or requisitioned for military use. Having made this decision, Congress, surprisingly in the view of some, extended the treatment to voluntary sales of assets used in a trade or business. See, generally, Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, 2d. ed., ¶ 54.1.1, pp. 54-4 and 54-5 (1990).

consistency of treatment of character as to the hedging transaction itself and timing rules affecting when losses will be recognized with respect to the hedging transaction, it has not sought, by regulation, to affect the treatment of the hedged asset, i.e., the fuel in our example.

We are sympathetic to the decision of the drafters of the Hedging Regulations to draw the line as they did, both for authority reasons and because of the potential opportunity for abuse described above. Nonetheless, we are ultimately persuaded that the Service and Treasury Department must, at a minimum, continue to consider a more expansive approach, both because many taxpayers have a legitimate tax policy case and because, as argued above, the government itself might not fully be protected under the approach contained in the Hedging Regulations.

There are essentially two approaches that could be taken to expanding the scope of the Hedging Regulations to deal with the supply case. The first and narrower approach is simply to adopt the proposal that supply hedges should be covered, while striving to limit, through both rules contained in the regulations and an audit program, hedging treatment to cases in which there is no substantial speculative or manipulative activity. We expect, however, that it would be difficult to devise rules providing meaningful protection to the government, at least without devotion of significant resources to audit. Moreover, we would expect strict scrutiny of this type to lead to many unproductive controversies between taxpayers and the government.

The second approach would be to allow broader hedging transaction treatment only if and to the extent that both character and timing rules apply to the hedged property. Thus,

for example, the fuel would, in effect, be treated as inventory. Taxpayers have argued that, in the supply case at least, there is authority under the general regulatory authority relating to inventory accounting for the Service to require that supplies be treated as inventory.⁶⁵ It appears, however, that substantial collateral considerations would be raised by requiring inventory treatment in all such cases.⁶⁶

A better variation of this approach would be to require the character of the underlying property to be changed only if hedging treatment is elected by the taxpayer. Because of the Service's broad authority to determine methods of accounting, it appears that the government may have the authority to implement such an approach by regulation.⁶⁷ If, however, the Service and Treasury remain concerned about their authority, we would support a request for legislation clarifying their authority to implement such an approach.⁶⁸

2. Similar Asset Hedges

Another issue raised by the Hedging Regulations is whether hedges involving assets similar to property which is

⁶⁵ The treatment of supplies in service industries has a long history. See, e.g., Francisco Sugar Co. v. Commissioner, 14 B.T.A. 1062 (1929) and Rev. Rul. 69-200, 1969-1 C.B. 60 (airplane parts owned by an airline do not constitute inventory).

⁶⁶ See, generally, Schneider, Federal Income Taxation of Inventories, § 1.03(2) (1993).

⁶⁷ In this connection, we note that, according to one commentator, the current practice of industry members is to treat current gains or losses on sales of excess capacity fuel as adjustments to deductible fuel costs. Air Transport Association, Letter of January 4, 1994, n. 4.

⁶⁸ Because of the opportunity for whipsaw inherent in the current approach, we question whether the revenue loss from such legislation, if any, would be significant. We also note that, if legislation were adopted, a conceptual case could be made for its extension to section 1231 assets.

ordinary property should qualify for hedging transaction treatment. This issue is arguably raised by the Hedging Regulations because the regulations require that the "ordinary property" be property that "is held or to be held by the taxpayer."⁶⁹

This issue is not a new one. In Kurtin v. Commissioner,⁷⁰ for example, the hedges in issue were butter futures contracts entered into to hedge cheese sales. The Tax Court concluded that the futures contracts closed out at a loss by the taxpayer were hedges within the meaning of G.C.M. 17322. More recently, this issue arose in the FNMA case. In that case, the taxpayer entered into short sales of Treasury securities as part of its hedging program. The Tax Court held that there was no same property requirement with respect to hedging treatment:

Respondent asserts that for a hedge to receive ordinary treatment under section 1221, it must involve the same property as is being hedged. We disagree. . . . Petitioner's assets which were the subject of petitioner's hedging transactions acted as surrogates for mortgage notes during the time periods between borrowing and lending decisions and their implementation. . . . Further, the emphasis in the cases . . . was on the use of the particular hedge . . . rather than that the asset could be acquired.⁷¹

Failing to extend hedging transaction treatment to these cases will not present the potential for abuse that failing to expand hedging treatment in the supply case allows. The taxpayer does not, in these cases, have the ability to take delivery of and use in its business an asset that gives rise to ordinary income treatment.

⁶⁹ Temp. Reg. § 1.1221-2T(b)(1)(i).

⁷⁰ 26 T.C. 958, acq., 1957-1 C.B. 4 (1956).

⁷¹ Federal National Mortgage Assn. v. Commissioner, 100 T.C. 541, 576 (1993).

Nonetheless, strong arguments can be made for extending hedging transaction treatment to cases such as this one. First, as was the case with respect to the taxpayer in Kurtin, some taxpayers will, as a practical matter, be unable to enter into hedges with respect to property which will be inventory or other "ordinary property" as to them. Second, in cases in which there is no speculative activity, it appears that the hedging gains or losses could be viewed as legitimately part of the ordinary costs of the taxpayers -- part of an "inventory purchase system".

Thus, we believe that the ordinary property requirement should be liberally interpreted. There is ample room under the current regulations to adopt such a liberal interpretation because hedges involving similar property can "reduce risk of price changes . . . with respect to ordinary property."⁷² Consequently, the fact that the taxpayer in question does not usually take possession and hold in inventory the particular variety of product or material (e.g., a particular type of wheat, or oil from a particular location) should not be determinative. More importantly, we believe that it should be clarified that hedging transaction treatment would apply to hedges involving assets, the price movements of which are expected closely to track price movements of property that is ordinary property.

Although we believe that there is a strong rationale for applying hedging transaction treatment liberally to this type of case, we note that this type of case does entail certain special considerations that require rules to prevent abuse by the taxpayer. Questions eventually will arise whether the asset in question really is, under the facts, a reasonable surrogate for the ultimate hedged asset, and these transactions may present a greater problem of enforcement to distinguish speculative from

non-speculative activity than do the supply cases. Moreover, because of the fact that some such property may give rise to capital gain upon sale, the potential for whipsaw exists. We suggest, therefore, that a rule be adopted that, if the taxpayer elects hedging treatment, assets actually delivered to the taxpayer under the hedge must be subject to ordinary treatment. Because these assets can be viewed as part of an inventory purchase system, we believe that, in this case, the Service clearly has authority to require such treatment without the need for legislation. If such a broad rule were adopted, there would, in our view, be no reason not to reach a favorable result under the facts of Kurtin or similar cases.⁷³

3. Hedge of Returns From Investment Assets

We have also considered whether hedging ordinary returns from investment assets should properly be the subject of hedging transaction treatment. As noted in the Bentsen Letter, under the Hedging Regulations, hedges of ordinary streams of income flowing from a capital asset, such as a bond held for investment by an insurance company, will give rise to capital gain or loss.

While we believe that the entire question of integration of tax treatment of returns from financial assets should continue

⁷² Reg. § 1.1221-2T(b)(1)(i).

⁷³ A proper policy result may also be achieved in some cases by actually including the hedges in inventory, whether or not the taxpayer identifies the transaction as a hedge. This question also has a long history, and we do not believe further consideration of this issue in specific cases should be precluded. See, e.g., Montfort of Colorado, Inc. v. commissioner, 561 F.2d 190 (10th cir. 1977); see also G.C.M. 17322, *supra* n.4.

to be considered by the Treasury Department, we believe that, at this point, it is reasonable for such transactions to be excluded from coverage under the Hedging Regulations. In addition to the considerations discussed above with respect to hedges involving similar assets, hedges of ordinary income flows of investment assets give rise to the question of whether disposition of any such assets really should give rise to capital or ordinary treatment; just as the sale of stock can be viewed as the sale of the future ordinary income flows from that stock, the disposition of a hedge of such flows could be viewed as capital in nature, irrespective of whether the disposition in question was in connection with the disposition of the investment asset. It appears to us that proper character rules with respect to such hedges should be worked out carefully for each type of hedge, in order to assure that the capital gain -- ordinary income distinction is appropriately made.

Assume, for illustration purposes, the following example. An insurance company owns certain interest paying corporate bonds. The bonds bear interest at a floating rate. The taxpayer insurance company enters into fixed interest rate swaps with respect to the bonds.

Assume, first, that the taxpayer disposes of the bonds and the swaps together. There would appear to be no reason to treat the gain or loss from the swaps differently than the gain or loss on the sale of the bonds. Both transactions, it would appear, should be treated as giving rise to capital gain or loss.

Now assume that only the swap position is sold. It is a more difficult question, from a policy point of view, how to treat this transaction. Nonetheless, it would appear this transaction should not necessarily be treated as giving rise to ordinary income or loss. Even when viewed separately from the bonds, the future cash flows from the swap differ only in degree from the future flows from a bond. The sale of a bond gives rise to capital gain or loss, and sales of stripped coupons from a bond give rise to capital gain or loss. Moreover, treatment of the gain or loss on the sale of the swap as capital is consistent with the anti-cherrypicking rationale of the capital loss limitation. Thus, the proper treatment of these transactions should be determined on a case by case basis, depending on the nature of the hedge and all the applicable tax policy considerations.

B. Risk Reduction

Under the Hedging Regulations, a hedging transaction is a transaction that a taxpayer enters into in the normal course of business to reduce the risk of interest rate or price changes or currency fluctuations. Commentators have questioned the use of the word "reduce" in this part of the test, suggesting, among other things, that the word "manage" be substituted.

Several separate, but interrelated questions are raised with respect to this issue, including: (i) what really is risk reduction, i.e., does it entail the reduction of maximum possible risk, or merely the reduction of a definable risk that potentially exists under certain circumstances; (ii) whether the taxpayer's position should be assessed in terms of the specific subject of the hedge or the overall risk of the enterprise; and (iii) whether the taxpayer should be able actually to increase

its risks under some possible conditions, so long as the hedging transaction can be viewed as part of the borrowing of funds or its regular business activities.

A simple example can usefully initiate our discussion. Assume that a taxpayer engaged in the widget manufacturing business has liabilities with fixed interest rates. With the purpose of reducing the risk that interest rates will decline in the future significantly below the fixed rates on such debt (thus increasing its costs vis-à-vis its business competitors), it enters into a hedging transaction (e.g., an interest rate swap) transmuting its risk on its liabilities into a LIBOR-based variable rate. Of course, if interest rates increase, it is possible that the taxpayer will be worse off as a result of the hedge. Should the taxpayer be viewed as reducing its risk with respect to the transaction within the meaning of the Hedging Regulations?

We believe that this transaction should be viewed as risk reduction in this case because the hedging transaction reduces a "risk" (i.e., increased relative costs of money) even though it may increase maximum risks under certain circumstances. From a business standpoint, a taxpayer may be in a better position to absorb the costs of future increased rates than to incur future costs at above market rates.. The Service should not substitute its business judgment for that of the taxpayer. Scrutiny by the Service of these types of transactions would be a singularly unproductive exercise in most cases, and the requirements for hedging transaction treatment should be treated as satisfied without such scrutiny. The Hedging Regulations should, by example, make absolutely clear that this type of transaction constitutes risk reduction and that hedging

transaction treatment will apply in such cases. The answer should be the same under section 1256(e).

The reduction of risk standard is also problematic with respect to so-called dynamic hedges, i.e. hedges entered into with respect to risks that are modified (either with new hedges or amendments) as time goes on. Any such modification might, viewed independently, in fact, increase the risk to the taxpayer, even though viewed from the perspective of the original transaction the hedges are risk reducing. Even if the risk reduction standard were interpreted strictly, we believe that such hedges should qualify, except to the extent that such hedges involve over-hedging or changes in the status of the hedged position.

Broader questions can be raised, however, in certain cases. Assume that the taxpayer in question, instead of being in the widget business, is in the financial services industry. Assume further that, ex ante, it has long-term financial assets that have fixed interest rate flows and that at the same time it has fixed rate, long-term interest rate liabilities that generally "match" those assets. In the face of this matched position, the taxpayer enters into a putative hedge with respect to a portion of its liabilities transforming its risk into a variable one, e.g., an interest rate swap under which its payments are floating. In this case, viewed from the perspective of the taxpayer's overall business, the taxpayer has arguably increased its risk. This case poses clearly the question whether a "manage" risk or similar standard should be substituted for a "reduce" risk standard.

While it might reasonably be argued that this type of transaction goes beyond mere hedging,⁷⁴ we believe that the policy justifications for applying the results of hedging treatment to this case remain quite strong. First, although the Service and Treasury Department have been careful in the Hedging Regulations not to address integration, the application of hedging treatment to this transaction does have the rational result of leading to a precise overall reflection of this taxpayer's cost of borrowing. Second, this taxpayer is in the financial services industry, and management of risk is clearly part and parcel of that business: artful management of the level of its financial risk, as opposed to elimination of that risk, is one way it maximizes its ordinary business profits. Finally, if the taxpayer did not enter into a hedging arrangement, it could achieve the same treatment by incurring liabilities with the same inherent risk (i.e., floating rate debt and fixed rate assets).

Similarly, a hedge of inventory, for example, that actually increases the price risk of the taxpayer could reasonably be viewed as properly giving rise to hedging treatment. In effect, any seller of goods is making money in part from the price risks it takes with respect to inventory, and management of that risk should be viewed as consistent with the conduct of that business.

In addressing the treatment of this type of case, we do not believe that the Service should consider itself constrained by the literal language of section 1256(e). It appears clear that Congress did not view the transactions described in section

⁷⁴ Indeed, it is possible that such a transaction would not come within the definition of hedge historically adopted by courts. See, e.g., Muldrow v. Commissioner, 38 T.C. 907, 913 (1962).

1256(e) as the only transactions of this type eligible for ordinary treatment.⁷⁵

The ultimate inquiry may appropriately be viewed as whether the hedge is "entered into in the normal course of the taxpayer's trade or business." In this regard, the so-called "stored on the Board" or "repurchase" case is instructive. Assume a taxpayer who grows grain that will be harvested in September. Assume further that shortly after the harvest, she sells her grain, and she enters into futures contract on the Board of Trade, under which she is long with respect to grain to be delivered in December at December prices. She then goes to Florida. At the time she enters into the futures contract, she no longer owns any grain, and the taxpayer has, in effect, restored her risky position in grain. Should this transaction be viewed as a hedging transaction so that gain or loss on the future is ordinary gain or loss?

In our view, rather than attacking this transaction under the risk reduction rule, the transaction might more rationally be addressed under the rubric of other rules. On the one hand, with respect to the taxpayer in this example, it may be possible to view this transaction as mere speculation, not "entered into in the normal course of the taxpayer's trade or business." On the other hand, this activity could, in some cases, be viewed as part of a broader, ordinary business activity. The taxpayer could simply be viewed as, in effect, making the decision when to sell her grain: if she had the actual storage

⁷⁵ Indeed, it was specifically stated that "[p]rior law rules characterizing as ordinary gain or loss on transactions constituting an integral part of a taxpayer's trade or business continue to apply so that ordinary income or loss may result from transactions that are not within the hedging exemption." General Explanation of the Economic Recovery Act of 1981 (H.R. 4242, 97th Congress; Public Law 97-34)

facilities, she could have stored the grain herself instead of "on the Board."

We believe it is appropriate for the Service to scrutinize these cases carefully. We would argue, however, that the Service should not feel compelled by the necessity of dealing with this type of case to adopt a strict view of the risk reduction standard generally.

C. Hedges of Related Party Risks

As noted above, the Hedging Regulations by their terms do not apply to related party risks, as is confirmed by the Preamble.⁷⁶ The technical reason for this result is that a hedging transaction is defined as a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business. While, as discussed below, it is clear that a significant number of technical and policy problems are posed with respect to the treatment of related party risks, we believe that, as a policy matter, it is quite important to cover certain hedging transactions with respect to related party risks. The importance of such a rule is increased by the fact that a large number of hedging transactions are, in fact, done in a manner that would technically not qualify for hedging transaction treatment under the current regulations.

A certain number of related party hedging transactions can be carried out in a manner that does not pose such technical problems. Thus, for example, guarantees by a parent of its subsidiaries' risks could avoid such issues. Similarly, a hedging center corporation can act as an agent for its affiliates. Many

prepared by the Staff of the Joint Committee of Taxation (hereinafter the "ERTA Blue Book") at 300.

⁷⁶ Preamble at 54038.

groups will, however, not wish to conduct their affairs in these ways, and we believe that forced changes in common business practices should, to the extent possible, be avoided.

In addition to timing questions (which are discussed in Part IV of this Report), two other types of issues are raised with respect to the question of related party risks. The first is whether hedging transaction treatment should be applied, i.e. should an ordinary gain or loss be permitted with respect to the transaction. With respect to this question, a major consideration is whether the relationship of the parties should be viewed as significant enough that the hedge is properly viewed as entered into with respect to a business as opposed to an investment. The second is what the location of gain or loss should be. The principal questions here are whether it should be located in the party whose property, obligations or liabilities are being hedged, or in the hedging party, and what other collateral effects the location of hedging treatment should have (e.g., deemed capital contributions or dividends, etc.).

We will treat separately two types of related party cases: hedges entered into with third parties with respect to related party risks, and back-to-back or similar hedging transactions entered into with related parties.

1. Hedges Entered Into With Third-Parties

- a. Affiliated Corporations Filing Consolidated Returns

The clearest case in which hedging transaction treatment should be granted with respect to hedges entered into with third parties is the case in which the related parties are members of the same affiliated group filing consolidated returns. Assume, for example, the following facts.

Parent and Sub are affiliated corporations filing consolidated returns. Sub is an operating company that is exposed to risk with respect to changes in the price of its inventory. Parent enters into a cash-settled forward contract with a third party to sell a specified quantity of such inventory.

Assuming that all other requirements are met with respect to Parent's hedge of the inventory of Sub, we believe that hedging transaction treatment is appropriate so that gain or loss on the hedge should be treated as ordinary. In this case, the affiliated corporation rules of section 1504 will ensure that Parent has a significant enough interest in Sub so that the hedge is a business hedge, not merely a partial hedge of a stock investment. In addition, permitting hedging treatment is fully consonant with one of the purposes of the consolidated return rules, i.e., to achieve the same treatment as would be achieved if the business conducted by the affiliated group were conducted in one corporate entity.

Assuming that hedging transaction treatment is granted, the question is what the location should be of such ordinary gain or loss, i.e., should it be viewed as incurred by Parent or Sub in our case? Even in the context of an affiliated group filing consolidated returns, location of gain or loss remains relevant - - e.g. in respect of the treatment of net operating losses.⁷⁷ In fact, at this point, location is relevant for purposes of determining character of income.⁷⁸

We have not fully considered all the possible approaches to this question, and any approach should be formulated

⁷⁷ See, e.g., Reg. § 1.1502-79; Reg. § 1.1502-21(c)(2).

⁷⁸ Reg. § 1.1502-13(c)(4).

consistently with the ongoing development of deferred intercompany transaction and investment adjustment rules. To address the location question fully, two different questions must be answered. First, is it predictable, ex ante, that in a range of cases overall income or loss will result to the hedging corporation from the hedging activity? Second, is such income or loss due to performance of an economic function (e.g., the commitment of capital to financial risks) which is rationally viewed as located in the hedging corporation? Although we have not examined these questions thoroughly, we expect that a strong case could be made that hedging gain or loss could be located in the hedging corporation without doing significant violence to applicable tax policies.

If, however, it were viewed as desirable to locate the tax consequences of the hedging transaction in the corporation with the underlying business activity, one possible approach would be modelled on that of the section 83 regulations.⁷⁹ Thus, in the case of the inventory hedging transaction described above, the hedging gain or loss on the cash settled forward would be treated as realized and recognized at the level of Sub. Parent would be viewed as making either a capital contribution (to the extent that it makes a payment under the cash-settled forward contract) or receiving a dividend (to the extent it receives a payment). Similarly, for example, if Parent entered into a hedge with respect to Sub's debt, the additional interest deduction or offsetting hedge payments would both be located in the Sub.

⁷⁹ See Reg. § 1.83-6(d)(1). See also Columbian Rope v. Commissioner, 42 T.C. 800 (1964), acq. 1965-1 C.B. 4; Young & Rubicam v. United States, 410 F.2d. 1233 (Ct. Cl. 1969); and PLR 8428062 (April 10, 1984).

If, instead, the two parties were both subsidiaries, payments or receipts with respect to the hedge would result in an inter-corporate dividend to the parent followed by a capital contribution to a subsidiary. If the hedge lost money so that the hedging corporation made a payment, the transaction would be treated as a dividend from the hedging subsidiary to the parent and a capital contribution to the operating subsidiary which would get the deduction (or offset to income). If the hedge made money, the transaction would give rise to income to the operating subsidiary, and such subsidiary would be viewed as paying a dividend to the parent and a capital contribution to the hedging subsidiary (which has the cash received under the hedge).

This approach may be more difficult to implement in practice in the case that a parent corporation or other hedging entity hedges the net, or a portion of the net, exposure of more than one subsidiary. If, for example, a parent hedged a portion of the net exposure of several subsidiaries manufacturing the same product, how should gains or losses under the hedge (with the correlative adjustments described above) be allocated?

Thus, unless it is determined to locate hedging gain or loss in the hedging corporation generally, the location question will be more difficult to resolve with respect to global hedges, i.e., hedges which hedge all or a portion of the net or aggregate liabilities of the group. The argument for permitting hedging treatment to such cases within the affiliated group filing consolidated returns remains quite strong under the policy underlying the consolidated return rules that the conduct of business activities through multiple corporations should not lead to results differing from those that can be obtained if the activities are conducted in a single corporation. We have not developed more concrete recommendations as to the proper

accounting for global hedges in an affiliated group filing consolidated returns. Nevertheless, we do not believe hedging transaction treatment for global hedges should be foreclosed in such cases.

b. Partnerships

Hedges entered into by partners with third parties with respect to the risks of a partnership entail policy issues similar, but not identical, to those posed with respect to members of a consolidated group. In such a case, the income from the hedged activity may appear on the hedging party's return. In addition, as in the consolidated return case, an approach based on the analogy of the section 83 regulations may be relatively workable because capital contribution/distribution treatment may not give rise to significant problems of implementation. Finally, in other areas of tax law, assets and activities of a partnership are, in effect, viewed as those of a partner therein.⁸⁰

Nonetheless, the strong policy underlying the consolidated return regulations is not present in this case. Moreover, in our experience, except in relatively limited cases, hedges are not often entered into by partners with respect to the activities of a partnership. Consequently, we believe that it would be reasonable for hedging transaction treatment not to be applied to such cases generally. However, we recommend consideration of an exception permitting a partner in a utility or other joint ventures to hedge, under certain circumstances, product that the partner will receive in kind from the partnership.

⁸⁰ See, e.g., Reg. § 1.861-9T(e) relating to allocation of interest deductions of a partnership. See also generally Reg. § 1.702-1(b).

In any case, except in the case described in the preceding sentence, we believe that a very significant relationship should be required to apply hedging transactions treatment in the case of partnerships. We suggest that hedging transaction not be granted unless the partner has a least a 33 1/3 interest in the partnership.

c. Related Corporations Not Filing Consolidated Returns

More difficult issues are raised with respect to affiliated corporations that do not file consolidated returns. In this case, the group's income would not be included on a return of each of its members. Moreover, the policy underlying the consolidated return rules would not be applicable. We believe, however, that because of the fact that related party hedges are common in such settings, further consideration should continue to be given to providing hedging transaction treatment.

The threshold question is what level of relatedness should be required. Again, the question is whether the hedge really should be viewed as a hedge with respect to a business, or, instead, an investment hedge. We believe, given the possible considerations, that requiring a degree of relatedness equal to that required for affiliation under section 1504 (i.e., 80 percent vote and value of stock other than straight preferred stock), but without the includible corporation rules would be appropriate.

It is possible that the collateral rules for location and other adjustments may be more important in this case because the income or loss will be reflected on separate returns and, indeed, may be subject to different marginal tax rates,

particularly in the context of affiliated entities in separate jurisdictions (e.g., a U.S. parent and foreign subsidiary). There are two possible approaches to the treatment of such hedging transactions. One is to develop rules like those described above that locate the hedging gain or loss in the corporation which conducts the business activities or has the losses. In this case, it may be more difficult to adopt an approach based on the section 83 regulations because inter-corporate transactions (e.g., dividends) have more significant effects. The second is simply to have an anti-abuse rule, with in terrorem effect.

Pending the development of a more detailed, concrete approach, we have no firm recommendation on the treatment of these transactions. We note that the most appropriate way to deal with such hedges may be to require that they be structured as back-to-back hedges, discussed immediately below.

2. Transactions Entered Into with a Related Party;
Back-to-back Arrangements

a. Character of Hedging Center's Gain or Loss

Related taxpayers sometimes centralize business risk in a "hedging center" by having the entities that are subject to a business risk enter into swaps, forwards, options or other transactions with the hedging center. In those circumstances, the Hedging Regulations as drafted would treat gain or loss of the entity subject to the business risk as ordinary, but would not clearly cover the hedging center. The regulations should clarify that the hedging center's gain or loss on such intercompany transactions (and hedges of those transactions) is ordinary to the extent it relates to ordinary property, borrowings or ordinary obligations of a related party.

Assume the following facts. On January 1, 1994, in order to hedge price risk with respect to inventory, Parent, a corporation engaged in manufacturing, enters into a cash-settled forward contract with Sub, a wholly-owned subsidiary of Parent (the "Parent-Sub Forward"). Under the forward contract, Parent agrees to sell a specified quantity of inventory to Sub on January 1, 1995, at the forward price for such inventory. That transaction transfers Parent's price risk with respect to the inventory to Sub. Sub then enters into an identical cash-settled forward contract with a third party (the "Third Party Forward") under which Sub agrees to sell the specified quantity of inventory on January 1, 1995, at the same forward price.

Conclusion. Because the Parent-Sub forward hedges ordinary property of Parent, Parent's gain or loss on that instrument is clearly ordinary under the Temporary Regulations. Sub's gain or loss on the Parent-Sub Forward and Third-Party Forward should also be ordinary because it relates to ordinary property of Parent, but the Hedging Regulations appear to make such gain or loss capital because (even if Sub entered into the Third-Party Forward "in the normal course of [Sub's] trade or business") the Parent-Sub Forward would appear not to be a hedge with respect to ordinary property.

b. Loss Disallowance

Section 267 disallows, or in the case of controlled groups of corporations defers, losses realized on the sale or exchange of property between related parties. The Hedging Regulations should clarify that section 267 does not apply to intra-group financial instruments that are part of a hedging strategy.

In the case of controlled groups not filing a consolidated return, assuming section 267 applies, section 267 deferral lasts only until the property is “transferred” outside the group, which would presumably be the time of exercise, settlement or termination of a hedge. That result is implied by Treasury Regulation Section 1.267(f)-1T(c)(1), which applies consolidated return principles for section 267 deferral purposes, and Treasury Regulation Section 1.1502-13(f)(l)(v), which triggers deferred intercompany gain when a third-party obligation is satisfied or becomes worthless. The result should, however, be clarified.

Assume the facts are the same as in the example above. In addition, on January 1, 1995, the price of the inventory has decreased below the forward price specified in the Forwards. As a result, Parent realizes a loss on its sale of inventory and a gain on the Parent-Sub Forward, and Sub realizes a loss on the Parent-Sub Forward and a gain on the Third-Party Forward. Conclusion. Sub should be entitled to recognize its loss on the Parent-Sub Forward. Section 267 would allow that result if the settlement of the Parent-Sub Forward were not a sale or exchange of property, because the Forward is treated as being transferred outside the Parent-Sub controlled group upon performance.

In the case of related parties that are not members of the same controlled group, section 267, if applicable, would prevent taxpayers from using back-to-back hedges, because it would permanently disallow the losses on such hedges. There is, however, no policy reason to discourage such back-to-back arrangements, and the Hedging Regulations should clarify that section 267 does not apply in such cases.

Assume the facts are the same as in the example above, except that Sub is a partnership in which Parent is a 99% partner. We believe that Sub should be entitled to recognize its loss on the Parent-Sub Forward.

III. PROCEDURAL RULES: THE EXCLUSIVITY RULE

As noted above, the Hedging Regulations comprehensively attack the problem of whipsaw. We believe that, taken as a whole, the regulations represent a very constructive initial attempt to deal with the whipsaw problem. We are continuing to consider, however, the workability in practice of the requirement that the hedged position be identified.

In this part of the Report, we will specifically comment on one aspect of the rules designed to eliminate whipsaw, the broad exclusivity rule. As discussed below, we believe that the rule should not be applied retroactively.

Under the exclusivity rule, “gain or loss on property, a short sale, or an option is ordinary on the grounds that the property, short sale, or option serves a hedging function only if the property, short sale, or option is part of a hedging transaction...”⁸¹ The Preamble provides, as an example of the application of this rule, that “if a transaction falls outside the regulations, gain or loss from the transaction is not made ordinary by the fact that the property is a 'surrogate' for a noncapital asset or that the transaction serves as 'insurance' against a business risk.”⁸²

At the outset, we should note that the precise scope of the exclusivity rule is not necessarily clear from the regulation itself. A financial transaction, for example, that increased a taxpayer's risks might be argued to give rise to ordinary income or loss because integrally related to an ordinary income producing activity of a taxpayer. Is such a transaction to be precluded, under the exclusivity rule, from ordinary income or loss treatment if it does not meet the definition of a hedging transaction treatment?

Assuming that the scope of the exclusivity rule is relatively clearly delineated, we believe that such a rule serves a very constructive function to the extent that it applies prospectively. In our view, a broad prospective exclusivity rule is appropriate, and would avoid the need for considerable wasteful litigation and controversy. The history of litigation in this area provides us with very little optimism that much constructive would come out of continued litigation of the scope of hedging transaction treatment.

⁸¹ Temp. Reg. § 1.1221-2T(a)(3).

⁸² Preamble at 54038.

We do not, however, believe that retroactive application of a broad exclusivity rule is justified. Therefore, we do not believe that the exclusivity rule should apply to transactions entered into in open years if the transactions were entered into before the Hedging Regulations were promulgated.

Although section 1256(e) hedging transactions likely do represent cases understood by Congress to be hedging transactions entitled to ordinary gain or loss treatment, there is no reason to believe that such transactions were understood by Congress to be the only such transactions.⁸³ The section 1256 rules arose in a context that did not entail that determination. Thus, we believe retroactivity of a broad exclusivity rule is not justified.

IV. PROPOSED TIMING REGULATIONS

As discussed in the Introduction to this Report, one of the central policy issues addressed by the government in formulating the Hedging Regulations was the proper timing of gains and losses from hedges. In this Part of the Report, we will comment on the proposed timing regulations contained in Proposed Regulation Section 1.446-4. As discussed above, the proposed timing regulations require generally that gain or loss from a hedging transaction be reasonably matched in time with the gain or loss from the corresponding hedged position (the “matching requirement”). Our conclusions concerning the proposed timing regulations are summarized in subparagraphs 7 through 13 of Part I.A. of this Report.

A. Authority to Require Matching

⁸³ ERTA Blue Book at 300.

In our view the Service has the clear authority to impose the matching requirement. We believe that section 446 authorizes the Service to require that gain or loss from a hedging transaction be taken into account in the same tax year as gain or loss from the corresponding hedged position, even if this means that gain or loss from a hedging transaction is taken into account earlier or later than the year in which it is realized. Section 446(b) requires that a taxpayer compute taxable income under a method that "in the opinion of the Secretary, does clearly reflect income." "The term 'method of accounting' includes not only the over-all method of accounting but also the accounting treatment of any item."⁸⁴ A "method of accounting" includes any method for determining the proper time for including an item in income or the taking of a deduction.⁸⁵

Under section 446(c), the Commissioner may use her section 446(b) authority to prevent a taxpayer from using an established and otherwise permissible method of accounting. For example, in certain circumstances, the Commissioner can use this power to require a taxpayer to change from the cash method to the accrual method even though the taxpayer is not precluded from using the cash method by statute or regulation.⁸⁶ Similarly, the Commissioner may use this power to defer a deduction even though the requirements for taking an expense into account under the accrual method have been met.⁸⁷ At least one commentator, noting the potentially broad scope of the Service's section 446

⁸⁴ Reg. § 1.446-1(a)(1).

⁸⁵ Reg. § 1.446-1(e)(2)(ii)(a).

⁸⁶ See American Fletcher Corp. v. United States, 832 F.2d 436 (7th Cir. 1987).

⁸⁷ See Ford Motor Co. v. Commissioner, 102 T.C._____, No. 6 (January 31, 1994).

authority, has suggested that this authority could be used to require taxpayers involved in tax shelters to use methods of accounting that reflect economic substance rather than methods of accounting specifically authorized by the Code.⁸⁸ There is substantial judicial and administrative precedent for use of section 446 authority to require use of a method of accounting that reflects the economic substance of a transaction and prohibit use of a well-established method of accounting. Examples include authorities requiring non-periodic or “upfront” payments on an interest rate swap or other notional principal contract to be taken into account over the life of the contract rather than when realized⁸⁹ and authorities requiring interest to be taken into account as it accrues economically rather than under the “rule-of-78s”.⁹⁰

In reaching our conclusion that the Service has authority to impose the matching requirement, we considered one argument to the contrary. It could be argued that Congress, in enacting section 1092, considered and specifically rejected a matching rule for business hedges. Congress, motivated by the same desire to prevent selective realization of losses that motivated the Service to impose the matching requirement in Proposed Regulation Section 1.446-4, enacted section 1092(a), which in effect imposes a matching requirement for straddles. Section 1092(a) generally requires that recognized losses from

⁸⁸ See Note, “Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion,” 83 Col. L. Rev. 378 (1983).

⁸⁹ Notice 89-21, 1989-1 C.B. 651 and Reg. § 1.446-3(f)(2) (requiring amortization of up-front payments on notional principal contracts).

⁹⁰ Rev. Rul. 83-84, 1983-1 C.B. 97 (relying on section 446 to deny deduction of interest liability determined under “rule of 78s” until it had accrued economically); Prabel v. Commissioner, 91 T.C. 1101 (1988), aff'd 882 F.2d 820 (3rd Cir. 1989) (upholding Rev. Rul. 83-84); Levy v. Commissioner, 92 T.C. 1360 (1989) (same); Mulholland v. United States, 28 Cl. Ct. 320 (1993) (same).

straddles be deferred and taken into account only to the extent that they exceed unrecognized gains from offsetting positions. This rule has the effect of requiring losses from transactions that are part of a straddle to be taken into account only at the same time as corresponding gains from offsetting positions. Section 1092(e) expressly exempts "hedging transactions"⁹¹ from this loss deferral rule. Thus, Congress considered whether to require losses from hedging transactions to be matched with corresponding unrealized gains from hedged positions and decided not to impose such a requirement. Consequently, an argument can be made that the Service does not have authority under section 446 to impose a requirement that Congress declined to impose.

We do not find this argument persuasive, however. The section 1092(e) hedging exception should not be viewed as preempting the Service's authority to deal in a comprehensive manner with hedging transactions. Instead, we think it reflects a decision by Congress not to deal in any way with the timing of gain or loss on business hedges when it enacted section 1092.

B. Policy Considerations

1. Need for a Matching Requirement

In addition, we support, as a policy matter, the Service's decision to exercise its authority to impose the matching requirement. As explained in more detail below, we agree with the Service's conclusion that the matching requirement is necessary to prevent selective realization of losses from hedging transactions. We also believe that it is appropriate to link

⁹¹ "Hedging transactions" has the same meaning in section 1092(e) as in section 1256(e). The section 1256(e) definition is, of course, the basis for the definition of "hedging transaction" in Temp. Reg. § 1.1221-2T and in the proposed timing regulations.

imposition of the matching requirement with regulations clarifying that hedging transactions produce ordinary rather than capital losses because, as explained below, the only policy justification for special treatment of capital losses is to prevent selective realization.

Without the matching requirement, taxpayers could use hedges of certain types of positions to defer income without economic risk in certain circumstances. Specifically, a taxpayer could enter into a hedging transaction knowing that, of the hedge and the hedged position, one will produce a loss and the other an offsetting gain. The taxpayer could then dispose of whichever of the two produced the loss, use the loss to shelter other income from tax, but retain the position that produced the corresponding gain.

Business considerations, of course, limit taxpayer control over the time at which gains and losses from hedged positions are realized. Taxpayers generally cannot choose to accelerate realization of losses from property held for sale to customers but delay realization of gains from such property.

Nevertheless, taxpayers do have control over the time at which they realize gains and losses from hedging transactions. In the absence of a matching requirement, a taxpayer that recognizes a loss from a hedged position would choose to defer recognition of the corresponding gain from the hedging transaction, while a taxpayer that recognizes a gain from a hedged position would choose to recognize the corresponding loss from the hedging transaction immediately. Thus, even though taxpayers may have limited control over the timing of gains and losses from hedged positions, they do have control over the timing of gains and

losses from hedging transactions. This control necessitates the matching requirement.

There are also certain circumstances in which taxpayers could control the timing of gains and losses on both the hedge and the hedged position in the absence of a matching requirement. Assume, for example, that a taxpayer issues fixed rate debt and enters into a floating-for-fixed interest rate swap. If interest rates fall, the taxpayer could recognize an immediate deduction by repurchasing its debt at a premium while deferring recognition of the offsetting gain on the swap.⁹² If interest rates rise, without the matching requirement, the taxpayer could recognize an immediate loss by terminating the swap while leaving its fixed rate debt--now trading at a discount--outstanding.

2. Linkage to Ordinary Treatment of Hedging Losses

We also believe that the matching requirement is appropriately linked to regulations clarifying that hedging transactions produce ordinary gains and losses. Although treating hedging losses as capital losses is a very poor way to address the problem of selective realization, such treatment can be justified, as a policy matter, only on this ground.

It is widely agreed that the capital loss limitation is justified as a way to prevent selective realization of losses.⁹³

⁹² See Reg. § 1.163-7(c); c.f. 12701 Shaker Boulevard Co. v. Commissioner, 36 T.C. 255 (1961), aff'd per, cur, 312 F.2d 749 (6th Cir. 1963) (prepayment penalty deductible; amortization over life of new mortgage not required because new mortgage was separate transaction).

⁹³ See e.g. The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 172 (1985); Federal Tax Treatment of Capital Gains and Losses: Hearings Before the House Comm. on Ways and Means, 98th Cong., 1st Sess. 23 (1983) (Statement of John E. Chapoton, Asst. Sec. for Tax Policy, Treasury Dept.) If capital gains were taxed at the same rate as ordinary income, as is the case for corporate taxpayers under current law, there would seem to be no other justification for distinguishing capital losses from ordinary losses.

Without the capital loss limitation, a taxpayer could enter into a number of risky positions knowing that, on average, some would produce losses and others gains. The taxpayer could choose to realize losses before gains, thereby reporting a loss for tax purposes and sheltering other income from tax even though it has suffered no economic loss. The capital loss limitation operates, in effect, to defer capital losses and match them with capital gains.

As applied to hedging transactions, however, the capital loss limitation is an ineffective solution to the problem of selective realization. Treatment of hedging gains and losses as capital does nothing to address selective realization if the hedged position produces a loss while the hedge produces a gain. If, however, the hedged position produces a gain while the hedge produces a loss, this system might prevent the loss from ever being used, thereby producing taxable income even though the transaction as a whole produces no economic income. Thus, some of the time the capital treatment of hedging transactions does nothing to prevent selective realization of losses; other times it permanently disallows losses, rather than deferring them.

3. Conflict Between Matching Requirement and Symmetric Treatment of Two Parties to a Hedging Transaction

Although we agree with the Service's decision to impose the matching requirement, we note that such consistency of treatment of the hedging transaction and the hedged position may lead to asymmetric treatment of the parties to the hedging transaction.⁹⁴ A taxpayer required to take gain or loss from a

⁹⁴ One commentator has discussed the concepts of consistency and symmetry in the taxation of financial products and has explained how rules designed to increase consistency may conflict with rules designed to increase symmetry. "Symmetry" is "equivalent treatment of the two sides to a single transaction" and "consistency" is "equivalent treatment by

hedging transaction into account before or after it is realized may, as a result, take it into account before or after the other party to the hedging transaction.

We do not, however, regard this asymmetry as troubling, except in the case of hedging transactions with related parties, which are discussed in a separate section below. We note that Congress has already created widespread asymmetry in the taxation of parties to derivative financial contracts by requiring mark-to-market accounting under sections 1256 and 475. Section 1256 requires mark-to-market accounting for, inter alia, regulated futures contracts and non-equity options, except in the case of taxpayers using these contracts as business hedges. Section 475 requires dealers in, inter alia, other derivative products most commonly used by businesses to hedge--notional principal contracts, forwards, options and short positions--to use mark-to-market accounting. Accordingly, the counterparties in business hedging transactions generally do not now account for gain or loss from such transactions when realized; there is no reason to believe that imposition of the matching requirement would increase the asymmetry that already exists.

C. Comments on Provisions of Proposed Timing Regulations

1. General Provisions

The proposed regulations generally require that the taxpayer's method of accounting for a hedging transaction reasonably match the timing of income, deduction, gain or loss from the hedging transaction with the timing of income,

a single taxpayer of two or more individual transactions making up parts of a larger overall transaction." See Shuldiner, "Consistency and the Taxation of Financial Products," 70 Taxes 781 (1992). The proposed timing regulations are an attempt to increase consistency.

deduction, gain, or loss from the item or items being hedged. The regulations note that taking gain or loss on a hedging transaction into account in the year realized will not clearly reflect income if the corresponding gain or loss on the hedged position is not realized in the same taxable year.⁹⁵ Thus, if the corresponding hedged position is still in place when a hedge is disposed of, gain or loss from a hedging transaction must be taken into account in a year after the year in which it is realized. If a taxpayer disposes of, or terminates the hedged position while the hedge is still in place, the taxpayer must “appropriately match” the built-in gain or loss on the hedging transaction with the realized gain or loss on the hedged position.⁹⁶

a. Effect on Timing of Gain or Loss from Hedged Position

It is noteworthy that the proposed timing regulations govern only timing of gain or loss from hedging transactions; they do not require or permit a taxpayer to take gain or loss from the hedged position into account in a year other than the year in which realized. Thus, the regulations do not permit a taxpayer to comply with the matching requirement by using a mark-to-market method of accounting for both the hedge and the corresponding hedged position unless the taxpayer would otherwise use mark-to-market accounting for the hedged position.⁹⁷ We recognize, however, that significant administrative (such as valuation), technical (such as interaction with the cancellation of debt income miles) and policy issues would arise in applying

⁹⁵ See Prop. Reg. § 1.446-4(b).

⁹⁶ See Prop. Reg. § 1.446-4(b)(5). The regulations state that the taxpayer may meet this requirement by marking the hedge to market.

⁹⁷ See Prop. Reg. § 1.446-4(e)(1).

mark-to-market accounting to certain types of hedged positions, principally liabilities of the taxpayer.

b. Integration Only as to Timing

The proposed timing regulations govern only the timing of income from hedging transactions. They do not integrate hedges and hedged positions, and thus they do not affect the type or character of gain, loss, income or expense. The matching requirement does not affect the computation of cost of goods sold or sales proceeds for a taxpayer that hedges inventory purchases or sales. Similarly, the matching requirement does not increase or decrease the interest income or expense of a taxpayer that hedges a debt instrument or a liability.⁹⁸

Thus, although loss on a hedge of inventory on hand will be taken into account at the same time as gain on the sale of inventory, it will be treated as a "below-the-line" deduction from gross income, rather than an "above-the-line" reduction in total sales or increase in cost of goods sold.⁹⁹ Similarly

⁹⁸ See Prop. Reg. § 1.446-4(f).

⁹⁹ Cost of goods sold is subtracted from total sales in computing gross income. See Reg. § 1.61-3(a). In contrast, losses and other deductions are subtracted from gross income in computing taxable income. See section 63(a).

The distinction may be important, as a theoretical matter, because statutory limitations on the deduction of expenses do not apply to items that are taken into account in computing gross income. See, e.g., Max Sobel Wholesale Liquors v. Commissioner, 630 F.2d 670 (9th Cir. 1980), aff'd 69 T.C. 477 (1977), acq., 1982-2 C.B. 2 (holding that section 162(c)(2), which denies a deduction for illegal payments, did not prevent the taxpayer from including in its cost of goods sold the cost of merchandise given as an illegal rebate); Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), acq., 1982-2 C.B. 56 (permitting illegal rebates to customers to be taken into account as "above-the-line" reductions in total sales, notwithstanding statutory prohibition on deduction of illegal payments); G.C.M. 34547 (July 1, 1971); G.C.M. 36510 (Dec. 8, 1975); but see R.J. Reynolds Tobacco Co. v. Commission, 15 T.C.M. 810 (1956), aff'd 260 F.2d 9 (4th Cir. 1958) (unreasonable

although gain or loss on a hedge of a debt instrument held or issued by the taxpayer may be taken into account at the same time as interest income or expense on that debt instrument, it will not affect the amount of the taxpayer's interest income or expense.

It is not clear how this rule would apply to treatment under section 263A(f) of gain or loss on a hedge of a debt instrument issued by a taxpayer to finance construction of an asset. We note that proposed regulations under section 263A(f) reserve as to the treatment of notional principal contracts.¹⁰⁰ We suggest that gain or loss on disposition of a notional principal contract that hedges a borrowing the interest on which is subject to section 263A(f) should be treated in the same way for timing purposes as the periodic payments or receipts on the contract would have been treated if the notional principal contract had been left in place. Thus, to the extent that those periodic payments or receipts would have increased or reduced the amount of interest required to be capitalized (or would have been taken into at the same time as if they increased or reduced the amount of interest required to be capitalized), loss or gain realized on disposition of the notional principal contract should be taken into account in this manner.

compensation could not be taken into account "above-the-line" through cost of goods sold).

The distinction may also be important in applying section 6501(e), which extends the statute of limitations on assessment of deficiencies if a taxpayer has understated gross income by more than 25 percent. See Prop. Reg. § 1.263A(f)-2(f)(6).

¹⁰⁰

c. Assumption of One-to-One Correspondence
Between Hedge and Hedged Position

The matching requirement, as articulated in the proposed timing regulations, assumes that there is a direct one-to-one correspondence between a hedging transaction and the items being hedged.¹⁰¹ The specific rules for hedges of debt instruments and, possibly, for hedges of inventory also assume a one-to-one correspondence between hedging transactions and particular hedged positions.¹⁰² This assumption is unrealistic as applied to the hedging activities of many, if not most, taxpayers. It is common for businesses to hedge their overall exposure to interest rate risk or price risk through “global hedges” rather than to hedge particular positions.

2. Provisions Applicable to Certain Types of Hedging
Transactions

a. Hedging of Inventory

The proposed timing regulations permit, but do not require, transactions that hedge inventory to be accounted for by treating the realized gain or loss on the hedging transaction as

¹⁰¹ Prop. Reg. § 1.446-4(b) requires matching of the gain or loss from “the hedging transaction” with gain or loss “from the item or items being hedged.”

¹⁰² Prop. Reg. § 1.446-4(e)(3) refers to gain or loss from a transaction that hedges “a debt instrument” and requires that it be taken into account for by reference to “the terms of the debt instrument and the period or periods to which the hedge relates”. Prop. Reg. § 1.446-4(e)(2), dealing with inventory hedges, refers to the “corresponding inventory.” It is not clear whether this reference is to an account or to specific items of inventory.

an adjustment to the cost or sales price of the inventory. This method would distinguish between two different types of hedges: (1) hedges against the risk of a drop in the price of inventory on hand ("hedges of sales") and (2) hedges against the risk of a rise in the price of inventory to be acquired ("hedges of purchases"). Under this method, gain or loss from a hedge of sales would be taken into account in the same period in which it would have been taken into account if it had been an adjustment to the sales price of "the inventory." Similarly, neither gain nor loss from a hedge of purchases would be taken into account in the same period in which it would have been taken into account if it had been an adjustment to the cost of "the inventory".¹⁰³

It is not clear whether the term "the inventory" in the description of this method in the proposed regulations was intended to refer to particular units of inventory (units on hand when the hedge is entered into, in the case of hedges of sales, or units purchased, in the case of hedges of purchases) or instead to the inventory account to which the hedge relates. If the term "the inventory" contemplates that a hedge will be associated with particular units held or to be held in inventory, how are taxpayers to track the units of inventory that are deemed to be hedged? Assume, for example, that the taxpayer has 100x barrels of oil in inventory and enters into a short forward contract for the sale of 40x barrels of oil at a fixed price. In year 2, while the forward contract is in place, the taxpayer buys

¹⁰³ Prop. Reg. § 1.446-4(e)(1).

60x barrels and sells 50x barrels. In year 3, the taxpayer disposes of the forward contract. Should the taxpayer be deemed to have sold the 40x barrels covered by the short forward contract in year 2, and thus be required to mark-to-market the hedge? Or should the taxpayer be deemed never to sell the 40x barrels covered by the forward contract as long as at least 40x barrels are on hand, so that the gain or loss realized on disposition of the forward contract in year 3 reduces or increases the value of ending inventory used in computing cost of goods sold? He re-commend that final regulations clarify that the term "the inventory" refers to an account and not to particular units.

The proposed timing regulations also permit other I methods for certain inventory hedges. They provide that taxpayers may take gains and losses on hedges of sales (as well as hedges of purchases) into account as adjustments to inventory cost. The proposed timing regulations do not permit taxpayers using LIFO to use this method. The apparent reason for denying this method to LIFO taxpayers is as follows. If gain on a hedge of sales were treated as an adjustment to inventory cost, this gain would be reflected as a lower carrying value for the taxpayer's LIFO layers and would never be recognized unless the taxpayer liquidates these layers. The corresponding loss on the hedged position would be recognized immediately through a reduction in total sales.

As another alternative, the proposed regulations provide that marking hedges to market may clearly reflect income even if the inventory being hedged is not marked to market, provided that the inventory is not accounted for under either LIFO or lower-of-cost-or-market, and provided that items are held in inventory for short periods of time.¹⁰⁴

The apparent reason for denying this method to taxpayers that use LIFO is as follows. In the case of hedges of purchases, the gain or loss on the hedged position (i.e., purchases at a lower or higher cost) will be reflected in part as a lower or higher carrying value for the taxpayer's LIFO layers and only in part through a lower or higher cost of goods sold for the year in which the purchases occur. Thus, unless the LIFO layers are liquidated, a portion of the gain or loss will never be recognized through cost of goods sold. In the case of hedges of sales, the gain or loss on the hedged position (i.e., increases or decreases in the value of inventory on hand) will never be taken into account through increased or decreased sales revenues unless these layers are liquidated. In either case, the concern apparently is that if hedging transactions are marked-to-market, gain or loss on the hedge will be taken into account immediately, while the corresponding gain or loss on the hedged inventory will never be taken into account.

¹⁰⁴ See Prop. Reg. § 1.446-4(e)(2)(ii)(C).

The apparent reason for denying the use of the mark-to-market method to taxpayers that use the lower-of-cost-or-market method of valuing their inventories is that combining the two methods would whipsaw the government. It would permit the taxpayer to deduct unrealized losses on hedges without including corresponding unrealized gains on the hedged inventory in income.

b. Hedges of Debt Instruments

The proposed timing regulations require that gain or loss from a hedge of a debt instrument be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. If the hedged instrument remains outstanding, gain or loss realized on disposition of a hedge is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates.¹⁰⁵ In effect, gain or loss realized on disposition of a hedge of a debt instrument that has already been issued is taken into account in the same periods in which it would have been taken into account if the hedge had been left in place.

Gain or loss realized from a transaction that hedged an anticipated borrowing for its entire term is taken into account as if it increased or decreased the issue price of the debt instrument.¹⁰⁶ As we interpret this rule, taxpayers that terminate or assign derivative contracts that hedge anticipated borrowings,¹⁰⁷ realizing a gain or loss, will be treated in the

¹⁰⁵ See Prop. Reg. § 1.446-4(e)(3).

¹⁰⁶ Id.

¹⁰⁷ Such derivative contracts may include forward rate agreements and forward contracts.

same way as taxpayers that exercise their rights (or perform) under such contracts.

D. Application of Matching Requirement to Particular Types of Hedging Transactions

In this section, we will consider appropriate timing rules for various types of hedging transactions that are not addressed, or are not addressed adequately by the proposed timing regulations.

1. Under-hedging

In order to apply the matching requirement to a hedging transaction that hedges less than the entire risk created by the corresponding hedged position ("under-hedging"), a stacking rule is needed. Should the first dollar of gain from the hedging transaction be treated as corresponding to the first dollar of loss from the hedged position? Assume, for example, that a taxpayer is long 150 barrels of oil, and hedges this exposure with a short futures contract covering only 100 barrels. Assume that the taxpayer realizes a loss of \$100 from the short futures contract, with a corresponding \$150 of unrealized gain on the long position. Should each dollar of this loss be allowed dollar-for-dollar against realized gain from the long position, beginning with the first dollar of realized gain ("stack first"), or should a dollar of this loss be allowed only as \$1.50 of this gain is realized ("pro rata"), or should no loss be allowed until \$50 of gain has been realized, and the loss allowed dollar-for-dollar thereafter ("stack last")?

We recommend that a taxpayer be permitted to use any of these three stacking rules, provided that the rule is used

consistently. Because hedging transactions are, in general, equally likely to produce gains and losses, this approach should not be capable of manipulation.

2. Global Hedges

It is common for businesses to enter into hedging transactions that do not correspond to any single hedged position. A business may monitor its net exposure to a particular type of risk and enter into a single derivative financial contract to hedge this net exposure. For example, a business that buys and sells wheat may have a number of different long positions, including both wheat on hand and contract rights to receive delivery of wheat from suppliers. The same business might have a number of different short positions, including contractual obligations to supply wheat to customers. The business might compute its net exposure to fluctuations in wheat prices and enter into one or more long or short futures contracts on wheat to hedge this exposure. These futures contracts would not correspond to any particular long or short position in wheat. The preamble to the proposed timing regulations invites comments regarding what guidance should be provided as to application of the matching requirement to such global hedges. We recommend that the final regulations permit taxpayers to apply the matching requirement to global hedges by establishing an account for each type of risk that they hedge against (a "mixed hedge account"). A taxpayer would identify both hedging transactions and hedged positions, including liabilities, subject to a particular type of risk to the account. In effect, every position in the account would be viewed as offsetting the risk from every other position in the account. We recommend that taxpayers be allowed considerable flexibility in determining how many different

accounts to set up and how to draw the boundaries between them, provided that the taxpayer is consistent.

Each mixed hedge account could consist of all hedging transactions entered into to reduce a particular type of risk and of all hedged positions subject to that type of risk. As an alternative to including all hedges and hedged positions relating to a particular risk in an account, positions could be excluded from the account to the extent necessary so that positions in the account exactly offset one another (i.e., positions in the account would not over-hedge or under-hedge each other). Thus, capital assets would not go into the account if inclusion resulted in over-hedging to a degree that is prohibited.

We have considered four possible alternative approaches for matching gains and losses from hedging transactions in an account with gains and losses from hedged positions in that account. First, the taxpayer might mark-to-market all positions in the account, recognizing both unrealized gains and unrealized losses on positions in the account each year. This approach is modelled on the mixed straddle account rules in Regulation Section 1.1092(b)-3T. We have not fully considered whether particular valuation problems would be raised for accounts that include liabilities.

Second, the taxpayer might be permitted to take into account realized losses in the account each year only to the extent of realized gains. Under this approach, realized losses in excess of realized gains from the account could be carried back or carried forward and used against realized gains from the account. Any deferred loss would be allowed when all positions in the account are disposed of. This approach is modelled on the capital loss limitation, but with one crucial difference;

although deduction of hedging losses would be limited, as would be the case if hedging losses were treated as capital losses, hedging losses would be allowable against the gains to which they correspond economically.¹⁰⁸ This approach, in contrast to the

¹⁰⁸ A possible objection to this approach is that positions in the account can be expected to generate more gain than loss, even if the taxpayer is exactly hedged (i.e., there is no over-hedging or under-hedging in the account). Hedged positions in the account might produce gains that are attributable to factors other than the risk being hedged. Such gains could be used to shelter losses attributable to the risk being hedged, with the result that the taxpayer could use a loss even though the offsetting gain (offsetting in that it is produced by the same price movement) is unrealized. These factors include (a) built-in gain in the hedged positions at the time they are added to the account (the solution to this problem is to mark hedged positions to market at the time they go into the account solely for purposes of determining the extent to which realized losses in the account can be used), (b) an interest-equivalent return from capital invested in positions in the account (a solution is to impute an interest return on the value of such positions at the time they go into the account and treat such return as unavailable for sheltering with realized losses) and (c) profit attributable to the fact that the taxpayer is in business (e.g., mark-up on wheat put in account).

We do not find this objection persuasive. A taxpayer can always predictably defer recognition of unrealized gain attributable to these factors even if it is not hedged. The purpose of the matching rule is to match gains and losses attributable to risk. A taxpayer's ability to defer gains attributable to other factors does not frustrate this purpose.

To illustrate the point, assume that a taxpayer has an unrealized gain in an account of \$100x, of which \$30x is attributable to a time value of money return on long positions in the account, \$30x is attributable to the taxpayer's "mark-up" on those long physical positions, and \$40x is attributable to risk (i.e., an unexpected rise in the market price of the long positions in the account). Assume that the taxpayer has a realized loss of \$40x from derivative contracts entered into to hedge the long positions in the account. Assume that the taxpayer realizes a \$40x gain from the long positions in the account. The taxpayer should be permitted to use the realized loss of \$40x to shelter this \$40x gain from tax. The taxpayer should be viewed as having deferred realization of gain attributable to a time value of money return on long positions and to its mark-up.

first dollar of realized gain from any asset in the account with deferred losses.

Third, the taxpayer might be permitted to take into account realized losses in the account except to the extent of net unrealized gains in the account. Under this approach unrealized gains in the account would be measured each year, and realized losses up to this amount would be deferred. Realized losses in excess of this amount would be allowed currently. This approach is modelled on section 1092(a). This approach, in contrast to the second, would never permanently disallow losses, but would require determination of market values, which may not be practical with respect to certain types of hedges and hedged positions. As under the second approach, deferred losses might either (a) be treated as realized in the following year or (b) be allocated among other assets in the account in such a way as to equalize basis and fair market value.

None of the three foregoing approaches would distinguish between hedges and hedged positions; all would override the realization rule with respect not only to hedging transactions but also with respect to hedged positions.

Under this fourth approach, a single mixed hedge account would be divided into two subaccounts -- one for "physicals" (i.e., inventory and other positions hedges of which would qualify as hedging transactions under Regulation Section 1.1221-2T) and another for "derivatives" (i.e., positions that qualify as hedges of positions in the physicals subaccount). There would

be no requirement to identify positions in the derivatives subaccount with specific positions in the physicals subaccount. The concept behind this approach is that the positions in the physicals subaccount are treated as a single hedged position and the positions in the derivatives subaccount are treated as a single hedge.

In contrast to the first three approaches, the timing at which realized gain or loss from positions in the physicals subaccount are taken into account would not be affected. Net realized loss from positions in the derivatives subaccount would first be recognized to the extent of net realized gain from positions in the physicals subaccount for the year. Any remaining net realized loss from positions in the derivatives subaccount would either (a) be treated as realized in the following year or (b) be allocated among all positions in the physicals subaccount as an adjustment to their basis. Any net realized gain from positions in the derivatives subaccount would be recognized to the extent of any net realized losses in the physicals subaccount.

If net realized losses in the physicals subaccount exceed net realized gain in the derivatives subaccount, any net unrealized gain in the derivatives subaccount would be recognized to the extent of the difference. Any remaining net realized gain from positions in the derivatives subaccount would either be recognized currently or, assuming that over-hedging and under-hedging in the account were prohibited, treated in a manner similar to remaining realized losses (i.e., either treated as realized in the following year or allocated among the positions in the physicals subaccount as an adjustment to their basis).

3. Inventory Hedges

The proposed timing regulations provide that hedges of inventory may be accounted for by treating realized gain or loss on the hedging transaction as if it were an adjustment to the cost or sales price of the corresponding inventory.¹⁰⁹ We recommend that the final regulations include this provision with the clarification that it does not involve tracking specific items in inventory; in fact, we believe that use of any other timing rule could distort business decisions. Accordingly, we believe that consideration should be given to making this approach mandatory.

In the case of hedges of inventory on hand (i.e., hedges of sales), this approach produces the same results regardless of whether the taxpayer performs under the hedging transaction or instead realizes gain or loss by terminating the contract. Assume, for example, that a taxpayer hedges against a decline in the price of oil in inventory by entering into a short forward contract. Assume that the price of oil rises, so that the short forward contract becomes a liability. The taxpayer can always choose to, in effect, take this loss into account immediately by selling oil from inventory under the forward contract at a price that is less than the current market price.

¹⁰⁹ Prop. Reg. § 1.446-4.

If regulations were to permit use of a method that defers realized gain or loss from a hedging transaction by treating it as an adjustment to inventory on hand, taxpayers would have an incentive to perform under their hedging contracts when their inventory has risen in price, but to sell or terminate those contracts when their inventory has fallen in value.

Similarly, in the case of hedges of anticipated purchases of inventory, this approach produces the same results regardless of whether the taxpayer exercises the derivative financial contract used to hedge purchases, or instead realizes gain or loss by terminating or selling the contract. Assume, for example, that a taxpayer enters into a long forward contract on a commodity that it uses as a raw material in producing goods held for sale to customers. If the commodity declines in value so that the contract generates a loss, this loss should be taken into account in the year realized as an increase in the cost of purchases for that year. Under this approach, the timing of the gain or loss would depend on whether purchases during the year are treated under the taxpayer's method of accounting for inventories as still on hand at the end of the year. Under this approach, the taxpayer's unit costs should be the same whether it disposes of the contract or instead exercises the contract.

Any other treatment could, at least in theory, distort taxpayer behavior. If the regulations were, for example, to permit gain or loss on disposition of the forward contract to be taken into account immediately even though some purchases during the year were treated as remaining on hand at the end of the year, taxpayers would exercise the futures contract in some cases but not in others. The taxpayer would have an incentive to sell the contract if the commodity fell in value, thereby realizing the full amount of the loss immediately, but to exercise the

contract if the commodity rose in value, thereby deferring the gain to the extent that purchases during the year are treated as remaining in inventory under the taxpayer's method of accounting.

If there is a net realized loss from hedges of sales in the tax year, and if this net realized loss exceeds income from the sale of the hedged inventory (i.e., total sales minus cost of goods sold), this excess should be carried forward and treated as (realized in the following year.

If there is a loss from the hedged inventory (i.e., if total sales exceed cost of goods sold), we recommend that any unrealized gain from hedges of sales be taken into account as an increase in the amount of total sales for the year, to the extent of the loss. Any realized gain from hedges of sales will already have been taken into account as an increase to total sales for the year.

The problems raised in applying the matching requirement to inventory hedges are closely analogous to the problems raised by global hedges. In both cases, it is difficult or impossible meaningfully to identify hedging transactions with specific hedged positions. The approach outlined above for inventory hedges is similar to the last of the four suggested approaches described in the previous section for applying the matching requirement to global hedges (although net gains from hedges are always taken into account currently rather than possibly deferred).

4. Hedging Transactions Entered Into With Related Parties

The preamble to the proposed timing regulations also invites comments as to whether special rules are needed for hedges entered into with a related party. The apparent concern is that, without special rules, application of the matching rule will result in a taxpayer taking gain or loss from a hedging transaction into account before or after the related party takes the corresponding loss or gain from the transaction into account.

We believe that special timing rules are necessary for hedging transactions with related parties, particularly where the two parties are not members of the same consolidated group. In the absence of such rules, the matching rule could be exploited in a way that would, in effect, permit taxpayers to deduct unrealized losses on hedged positions without requiring them to include unrealized gains. In cases in which the hedged position falls in value and the hedge rises in value, the taxpayer could terminate the hedge with the related party, thereby realizing a gain, which would be deferred and matched with the unrealized loss on the hedged position. As a result of the termination, the related party would realize a loss, corresponding to the deferred gain realized by the taxpayer. Unless the related party is also hedged, this realized loss would not be deferred. In effect, the taxpayer could, by terminating the hedge, accelerate recognition of the unrealized loss in the hedged position and shift it to the related party. If the hedged position rises rather than falls in value, the taxpayer would not terminate the hedge with the related party and thus would avoid accelerating recognition of the unrealized gain in the hedged position.

To prevent taxpayers from using related party hedging transactions in combination with the matching rule to selectively accelerate recognition of unrealized losses, we recommend that the gain or loss realized by a related party upon the termination of the hedging transaction be deferred and taken into account only when the corresponding gain or loss realized by the taxpayer is taken into account under the matching rule.

V. CHANGE IN STATUS OF A HEDGE

In this Part V of the Report, we will consider the timing and character issues that arise if a transaction that satisfies the definition of a hedging transaction at the time that it is entered into ceases to do so. We will consider three different situations in which such a “change in status” may occur: (1) a hedged position is disposed of before the corresponding hedge; (2) an anticipatory hedge is disposed of at or about the same time that the taxpayer decides not to enter into the anticipated hedged position; and (3) an anticipatory hedge is left in place after the taxpayer decides not to enter into the anticipated hedged position. Our recommendations in this Part are summarized in subparagraphs 14 through 16 in Part I.A. of this Report.

We note that the issues considered in this Part will not arise in the case of global hedges if our recommendations regarding mixed hedge accounts in the previous Part are accepted and if the change of status does not result in “over-hedging” to a degree that would require removal of the hedge from the account.

A. Hedged Position Disposed of Before Hedge

In the first situation, the hedging transaction hedges the risk from a position that is already in place, or that is established at the same time as the hedging transaction, but which is disposed of while the hedge is still in place. Hedged positions that are already in place when a hedge is entered into, but which are disposed of before the hedge, could take a number of forms. These include: debt issued by the taxpayer, inventory on hand, other ordinary property on hand, a contractual obligation to deliver ordinary property and a contractual obligation to buy ordinary property.

In this situation, except in the case of hedges of inventory on hand, we recommend that the hedge be marked-to-market at the time of disposition of the hedged position. Previously accrued unrealized gain or loss on the hedge would be taken into account at the same time as gain or loss from the hedged position. Such unrealized gain or loss would be ordinary. Any gain or loss that accrues on the hedge after the hedged position is disposed of would be capital and would be taken into account when realized. Our recommendation as to timing is consistent with Proposed Regulation Section 1.446-4(e)(5).

Under an alternative approach, all gain or loss on a hedging transaction, including that accruing after disposition of the hedged position would be ordinary. An argument for this approach is that it is not capable of manipulation since, at the time that the hedging transaction is entered into, the taxpayer does not know whether it will produce a gain or a loss. A counterargument is that if losses accruing after the hedged position is disposed of were to be treated as ordinary, the taxpayer could selectively realize such losses and use them to shelter other income from tax, while deferring realization of any gains accruing after disposition of the hedged position.

In the case of hedges of inventory on hand, as discussed in Part IV above, we do not recommend the mark-to-market approach, and instead recommend that gain or loss on the hedge be treated as an adjustment to total sales in the year in which it is realized. We do not believe that hedges of inventory on hand can or should generally be identified with particular units. Even if a hedge of inventory could be identified with particular units on hand, and those units were viewed as having been disposed of, the hedge should be viewed as hedging other items added to inventory. In these respects, inventory hedges are closely analogous to global hedges. Thus, so long as the total number of items in inventory is not less than the number of items covered by the hedge, the hedge's status should not be viewed as having changed.

B. Anticipatory Hedge Disposed of at Time Taxpayer Decides Not To Enter Into Anticipated Hedged Position

In the second situation, the hedging transaction hedges an anticipated future position (such as a borrowing or the purchase of raw materials), but the taxpayer decides not to enter into the position and closes the hedging transaction at or about the same time. In this case, we recommend that gain or loss realized on the hedge be treated as ordinary and be taken into account at the same time as it would have been taken into account if the anticipated hedged position had been entered into. Accordingly, for hedges of anticipated borrowings, the gain or loss on the hedge would be taken into account over what would have been the term of the borrowing. For hedges of purchases of raw materials or other items for inventory, the gain or loss on the hedge would be taken into account as an adjustment to current year purchases.

The proposed timing regulations do not answer the question of how to account for gain or loss on an anticipatory hedge where the asset that the taxpayer anticipated purchasing is not purchased or the liability that the taxpayer anticipated incurring is not incurred. In the preamble to the proposed regulations, the Service has invited comments with respect to whether the gain or loss realized on the hedge should be taken into account over the term that the asset would have been held or the term that the liability would have been outstanding, or whether some other treatment is appropriate.

Before deciding on this recommendation, we considered three alternative approaches. First, the taxpayer might be permitted to recognize loss on the hedge (and required to recognize gain) when it is realized, rather than taking it into account over time. The argument for this approach is that, if the anticipated hedge position is not in fact entered into, there is nothing with which to match gain or loss from the hedge. Taking losses from the hedge into account when realized better measures the taxpayer's economic income than does deferring the loss. In contrast to the situation in which the realized loss on a hedge is offset economically by an unrealized gain on a hedged position, the realized loss represents a real diminution in the taxpayer's net worth, which should be taken into account immediately.¹¹⁰ This argument, of course, applies with equal force if the taxpayer does enter into the anticipated hedged position. In that case, the realized loss also represents a real diminution in the taxpayer's net worth.

¹¹⁰ The treatment of unsuccessful bidding and proposal costs is consistent with allowing an immediate deduction. Such costs are not required to be capitalized. See Reg. § 1.263A-a(e)(3)(ii)(T).

The principal argument against this approach is that it may distort taxpayer decisions as to whether to enter into the anticipated hedged position and, in effect, permit selective realization of losses on hedges. If the anticipatory hedge generates an unrealized gain, it could be argued, the taxpayer will choose to enter into the anticipated hedged position. By doing so, the taxpayer will both "lock in" the gain economically -- since any decline in value of the hedge will be offset by an increase in the value of the hedged position -- but defer recognition of the gain for tax purposes.¹¹¹ In contrast, if the anticipatory hedge generates an unrealized loss, the taxpayer will choose not to enter into the anticipated hedged position, thereby taking the loss into account immediately.

Second, the hedge might be treated as though it never were a hedge, because the taxpayer did not enter into the anticipated hedged position. Thus, any gain or loss would be capital. This approach would distort behavior. It would encourage taxpayers not to enter into the anticipated hedged position if the disposition of the hedge will result in a gain, so that the gain would be capital. If the disposition of the hedge will result in a loss, the taxpayer would be encouraged to enter into the anticipated hedged position, so that the loss would be ordinary.

Because of this potential effect of the first two approaches on taxpayer behavior, we believe that a third approach -- which is consistent with the suggestion in the preamble to the

¹¹¹ Entering into the anticipated hedged position in this situation is analogous to a "short sale against the box". In this transaction, a taxpayer holding an appreciated stock sells it short, thereby protecting against the risk of a decline in value without realizing any gain for tax purposes.

proposed timing regulations -- should be adopted. Realized gain or loss from the hedge should be deferred and taken into account over the same time period that it would have been taken into account if the taxpayer had in fact entered into the anticipated hedged position.

We recommend different rules in the cases of (1) a hedge of an anticipated borrowing or of the anticipated purchase of a non-inventory asset and (2) a hedge of anticipated purchases of supplies, raw materials or other items for inventory.

In the case of a hedge of an anticipated borrowing or of the anticipated purchase of a non-inventory asset, the taxpayer would be required to specify the anticipated life of the hedged position at the time that the anticipatory hedge is entered into. We recognize that the anticipated life of the hedged position specified when the hedge is entered into may be different from the actual life of the hedged position if the hedged position is in fact entered into. Should the actual life be used to amortize the gain or loss on the hedge or the originally estimated life? If the actual life is used, the taxpayer would have an incentive either to enter into or not to enter into the hedged position based on (i) whether the hedge has produced a gain or a loss or (ii) whether the actual life of the hedged position is longer or shorter than the estimated life.

There are two possible responses to this incentive: (i) remove this incentive by requiring the taxpayer to amortize gain or loss from the hedging transaction over the same period regardless of whether the anticipated hedged position is, in fact, entered into, and (ii) accept this incentive, and recognize that any distortions of behavior that it creates are less than those that would be created by a rule that permits losses on

anticipatory hedges of positions that are not entered into to be taken into account immediately.

In the case of a hedge of anticipated purchases of supplies, raw materials or other items for inventory, we recommend that gain or loss on the disposition of the hedge be treated as an adjustment to purchases in the year in which realized. Under this approach, realized gain or loss on the hedge is taken into account at the same time that it would have been taken into account if the anticipated hedged position had been entered into.

C. Anticipatory Hedge Remains in Place After Taxpayer Decides Not to Enter into Hedged Position

In the third situation, the hedging transaction hedges an anticipated future position, and the taxpayer decides not to enter into the position but leaves the hedge in place. In this case, we recommend that the taxpayer be treated as if it had sold the hedge at that time (as in the second situation) and had reestablished the position. Thus, the hedge would be marked-to-market and previously accrued gain or loss would be taken into account as ordinary gain or loss at the same time that it would have been taken into account if the hedged position had been entered into (as in the second situation). Any subsequently accruing gain or loss on the hedge would be capital and would be taken into account when realized.

This situation is similar to the first situation in that the hedge remains in place after it serves a hedging function. In contrast to the first situation, however, the time at which the hedge ceases to serve a hedging function is more difficult to identify with certainty. It is more difficult to determine when a

taxpayer's intent changes than to determine when a specifically identified position is disposed of.

Thus, we considered an alternative approach in which no attempt would be made to determine when the taxpayer's intent changed if the hedge remains in place. Under this approach, the character of gain or loss on the hedge would not be bifurcated; all gain or loss from a transaction that was originally a hedging transaction would be ordinary and would be taken into account at the same time that it would have been taken into account if the hedged position had been entered into.

Although we do not recommend adoption of this approach, we recommend that a hedge be marked to market and bifurcated for character purposes only if it is not disposed of within some reasonable time period after the taxpayer decides not to enter into the anticipated hedged position. One possible time period would be 90 days. Another possible approach would be to require the hedge to be marked to market and its character bifurcated unless the hedge is disposed of by the end of the taxable year following the year in which the taxpayer decides not to enter into the anticipated hedged position.

VI. HEDGING TREATMENT OF INTERNATIONAL TRANSACTIONS

This section comments on three areas in which the Hedging Regulations intersect with international tax rules: hedges involving foreign currency transactions, the treatment of hedging gains and losses under subpart F and the treatment of hedging losses under the interest allocation rules of section 864(e). Our recommendations in this Part are summarized in subparagraphs 17 through 19 of Part I.A. hereof.

A. Foreign Currency Transactions

Temporary Regulation Section 1.1221-2T(a)(4)(i) provides that the characterization rule for hedges does not apply to gain or loss realized on a section 988 transaction (as defined in section 988(c)(1)) or to any qualified fund (as defined in section 988(c)(1)(E)(iii)).¹¹² It does apply, however, to transactions or payments that would be subject to section 988 but for the date that the transactions were entered into or the date that the payments were made. Section 988(c)(1) defines the term "section 988 transaction" to mean any one of three types of transactions if the amount which the taxpayer is entitled to receive (or is required to pay) by reason of such transaction is denominated in terms of a nonfunctional currency, or is determined by reference to the value of 1 or more nonfunctional currencies. The three types of transactions are: (i) the acquisition of a debt instrument or becoming the obligor under a debt instrument, (ii) taking into account for tax purposes any item which is to be paid or received after the date on which it is taken into account, and (iii) entering into or acquiring any forward contract, futures contract, option, or similar financial instrument (a "qualified financial instrument"). The disposition of nonfunctional currency is also a section 988 transaction.

1. Characterization of Section 988 Transaction Gain or Loss Other Than Foreign Currency Gain or Loss

¹¹² "Qualified funds" are partnerships that (i) are principally engaged in buying and selling options, forwards and futures, (ii) elect to exempt certain of their gains and losses from the general, ordinary gain or loss treatment of Section 988 and (iii) meet certain other requirements. Because the analysis of whether qualified funds' gains and losses should be exempt from the application of the Hedging Regulations is the same as the analysis of whether foreign currency transactions generally should be exempt from the application of the Regulations, qualified funds will not be addressed separately herein.

Section 988(a) prescribes characterization rules for “foreign currency gain or loss” attributable to a section 988 transaction. With two significant exceptions, Section 988 does not determine the character of gain or loss attributable to a Section 988 transaction other than foreign currency gain or loss.

Under the first exception, if the section 988 transaction consists of entering into or acquiring any qualified financial instrument, all gain or loss on the transaction is treated as foreign currency gain or loss.¹¹³ Under the second exception, if the section 988 transaction is part of a “section 988 hedging transaction,” the components of the section 988 hedging transaction are integrated under rules that have the effect of determining the character of gain or loss on the hedge with reference to the character of gain or loss on the hedged transaction.¹¹⁴

Thus, section 988 will determine the character of all the gain or loss, not just the foreign currency gain or loss, on a section 988 transaction if the section 988 transaction either is a qualified financial instrument or is part of a section 988 hedging transaction. If, however, a section 988 transaction neither consists of the acquisition of a qualified financial instrument, nor forms part of a section 988 hedging transaction, section 988 generally will not determine the character of the gain or loss on the transaction other than foreign currency gain or loss.¹¹⁵

¹¹³ Code § 988(b)(3).

¹¹⁴ Reg. § 1.988-5.

¹¹⁵ For example, assume that a taxpayer with the dollar as its functional currency acquires a deutschemark-denominated debt instrument to hedge the currency risk on swiss franc-denominated debt that it issues. Assume further that the hedge falls short of the requirements for integration under section 1.988-5(a). Acquisition of the deutschemark-denominated debt instrument will likely constitute a section 988

If a section 988 transaction is used as a hedge and the gain or loss thereon must be bifurcated as described in the previous paragraph, one would logically seek to determine the character of the non-foreign currency gain or loss under the Hedging Regulations. The Hedging Regulations as currently drafted, however, do not determine the character of non-foreign currency gain or loss on such a hedge. They do not apply to any gain or loss on a section 988 transaction.¹¹⁶

As discussed below, the inapplicability of the Hedging Regulations to section 988 can best be justified on the grounds that specific, well reasoned and well settled rules (section 988) were intended by Congress to pre-empt more general rules (such as the Hedging Regulations). This justification is not present where section 988 does not affect the character of gain or loss. Therefore, we believe that the character of gain or loss that is not affected by section 988 should, in general, be determined under the Hedging Regulations, even if that gain or loss is realized on a section 988 transaction.

2. Characterization of Foreign Currency Gain or Loss and Other Gain or Loss Realized in Section 988 Hedging Transactions

The larger issue, however, is whether the character of foreign currency gain or loss (and other gain or loss realized on a section 988 transaction that is part of a section 988 hedging transaction) (collectively, "section 988 gain or loss") should be

transaction the gain or loss on which will have to be bifurcated into foreign currency gain or loss and other gain or loss. Section 988 will determine the character of only the foreign currency gain or loss.
Temp. Reg. § 1.1221-2T(a)(4).

¹¹⁶

determined under the standards of the Hedging Regulations rather than the standards of section 988.

The answer to this question depends on the answers to three other questions: First, has Congress evidenced an intent that section 988 pre-empt other rules for the characterization of section 988 gain or loss? Second, would section 988 gain or loss have the same character under section 988 and under the Hedging Regulations? Third, even if the answers to the first two questions are "no", are the policies behind the section 988 characterization rules sufficiently well thought out, and the rules sufficiently well settled, to warrant the precedence of section 988?

We believe that the answers to all three questions are "yes". Therefore, we believe that the Hedging Regulations properly do not apply to section 988 gain or loss,

a. Congressional Intent

Code section 988(a)(1)(A) provides:

Except as otherwise provided in this section, any foreign currency gain or loss attributable to a section 988 transaction shall be computed separately and treated as ordinary income or loss (as the case may be).

Under code section 988(d), to the extent provided in regulations, integration applies to section 988 hedging transactions "for purposes of [all income tax provisions in the Code]."

The Senate Report accompanying the introduction of section 988 states: "The bill sets forth a comprehensive set of

rules for the treatment of foreign currency denominated transactions. . . ."¹¹⁷

The foregoing indicates a Congressional intent that, to the extent a transaction is a section 988 transaction, or is a part of a section 988 hedging transaction, the character of gain or loss realized thereon must be determined under section 988. This conclusion is particularly compelling where, as here, the alternative is to determine the character of the gain or loss under interpretative regulations, not legislative regulations. Therefore, although it is not entirely free from doubt, we believe that Congressional intent indicates that the character of section 988 gain or loss should not be determined under the Hedging Regulations.

b. Would the Results be the Same Under The Hedging Regulations and Under Section 988?

In the great majority of cases, it will be irrelevant whether gain or loss is characterized under section 988 or under the Hedging Regulations. Section 988 characterizes as ordinary all gain or loss on a section 988 transaction that is used as a hedge, to the extent that such gain or loss is: (i) foreign currency gain or loss, (ii) gain or loss on a qualifying financial instrument, or (iii) gain or loss on a transaction integrated with another transaction that produces ordinary gain or loss under the section 988 hedging rules. If the Hedging Regulations applied to such gain or loss, it would also be characterized as ordinary gain or loss, assuming that the Hedging Regulations' ordinary property and identification rules were met.

¹¹⁷ Sen. Rep't. No. 99-313, 99th Cong., 2d Sess. at 455 (May 29, 1986) (emphasis added) (hereinafter "1986 Senate Report").

Other gain or loss on a section 988 transaction may be characterized as capital gain or loss. This would include gain or loss on a section 988 transaction used as part of a section 988 hedging transaction and integrated with a transaction producing capital gain or loss. Under the Hedging Regulations, gain or loss on any transaction used to hedge risk on a transaction producing capital gain or loss also would be denied ordinary gain or loss treatment.

Thus, the results under section 988 will, in the great majority of cases, be the same as they would if the carve-out in the Hedging Regulations for section 988 transactions did not exist.

c. Rule-Making Process and Taxpayer Familiarity with Current Rules

The Senate Finance Committee report accompanying the adoption of section 988 stated: "characterizing exchange gain or loss as ordinary income or loss for most purposes is a pragmatic solution to an issue about which tax scholars and practitioners hold disparate views (i.e., whether exchange gain should be treated as interest for all purposes]." ¹¹⁸ Thus, section 988 was enacted only after consideration of the underlying policy issues.

Moreover, the regulations under section 988 consist of complex rules promulgated only after the Treasury Department took into account the views of this organization and other commentators, including our views with respect to section 988 transactions entered into for hedging purposes. ¹¹⁹

¹¹⁸ 1986 Senate Report at 452.

¹¹⁹ See New York State Bar Association Tax Section, Report on Section 988 Temporary Regulations, May 8, 1990 (published in Tax Notes Today, May 18, 1990); Preamble to T.D. 8400, 1992-1 C.B. 101.

In short, section 988 and the regulations there-under were adopted only after just the sort of deliberative process we have encouraged, and the absence of which we have recently decried.¹²⁰ In this context, a strong case exists that section 988 should take precedence with respect to those issues to which it applies.

B. Subpart F

Sections 954(c)(1)(B), (C) and (D) identify three types of transactions ("FPHCI Transactions") the excess of gains over losses on which satisfy the definition of foreign personal holding company income ("FPHCI") and, therefore, are includible in U.S. shareholders' income under subpart F. The Code and regulations attempt to include investment-type transactions in the definition of each FPHCI Transaction. Conversely, they attempt to exclude active transactions undertaken in the ordinary course of a taxpayer's trade or business. In general, then, passive gains and losses are included in the FPHCI calculation while active gains and losses are excluded from the FPHCI calculation.

¹²⁰ See Letter of John A. Corry, Chair of New York State Bar Association Tax Section, to Hon. Dan Rostenkowski, dated July 16, 1992, regarding proposal to repeal the so-called "stock-for-debt exception."

Consistent with this scheme, each of the three types of FPHCI Transactions contains an exception for hedging transactions entered into in connection with the active conduct of the taxpayer's trade or business. The first type of FPHCI Transaction is a sale or exchange of property that gives rise to passive income, such as stock, and certain other sales or exchanges.¹²¹ The Code and regulations provide an exception from FPHCI treatment for gains and losses from the sale or exchange of inventory property.¹²² In addition, the Code and regulations provide an exception for gains and losses arising out of certain hedging transactions that reduce the risk of price changes in the cost of such inventory.¹²³

The second type of FPHCI Transaction is a transaction in commodities.¹²⁴ The Code and regulations provide an exception from FPHCI treatment for active business gains or losses from certain sales of commodities ("qualified active sales").¹²⁵ In addition, the Code and regulations provide an exception for gains and losses arising out of certain hedging transactions entered into primarily to reduce the risk of price change with respect to commodities sold or to be sold in qualified active sales.¹²⁶

The third type of FPHCI Transaction is a foreign currency transaction.¹²⁷ The Code and regulations provide an exception from FPHCI treatment for certain transactions that are

¹²¹ Code § 954(c)(1)(B).

¹²² Id.; Temp. Reg. § 1.954-2T(e)(2)(ii)(B).

¹²³ Id.; Temp. Reg. § 1.954-2T(a)(4)(ii).

¹²⁴ Section 954(c)(1)(C).

¹²⁵ Section 954(c)(1)(C)(ii); Temp. Reg. § 1.954-2T(f)(1), (f)(3).

¹²⁶ Section 954(c)(1)(C)(i); Temp. Reg. § 1.954-2T(f)(1), (f)(3), (f)(4).

¹²⁷ Section 954(c)(1)(D).

not entered into for investment or speculation and that are attributable to transactions that relate to the active conduct of the taxpayer's trade or business ("qualified business transactions").¹²⁸ In addition, the Code and regulations provide an exception for gains and losses arising out of certain hedging transactions entered into primarily to reduce the risk of currency fluctuation with respect to property or services sold or to be sold, or expenses incurred or to be incurred, in transactions that are qualified business transactions.¹²⁹

It is clear from the foregoing that the Code and regulations under subpart F provide detailed rules governing the determination of whether a transaction is a hedge for purposes of the FPHCI calculation. However, if a transaction is not a hedge, the capital or ordinary character of the gains or losses on the transaction will, nevertheless, have an effect on the actual income inclusion of the taxpayer.¹³⁰

Temporary Regulation Section 1.1221-2T(a)(4)(ii) provides that the definition of hedging transaction in the Hedging Regulations does not apply "for purposes of" hedges entered into in connection with the second and third types of FPHCI Transactions. It is silent with respect to hedges entered into with respect to the first type of FPHCI Transaction. This provision raises two questions: (i) what is the intended effect

¹²⁸ Id.; Temp. Reg. § 1.954-2T(g)(2)(ii), (g)(3).

¹²⁹ Id.; Temp. Reg. § 1.954-2T(g)(4).

¹³⁰ See Reg. § 1.952-2(a)(1) (requiring gross income of foreign corporations to be determined for purposes of subpart F by treating foreign corporations as domestic corporations). See also Temp. Reg. § 1.954-2T(e)(1)(i), (f)(1), (g)(1) (providing that a loss that is deferred or otherwise not taken into account under any provision of the Code (presumably including the section 1211 capital loss limitation) may not be taken into account for purposes of determining FPHCI under the rules applicable to FPHCI Transactions).

of the provision on the second and third types of FPHCI Transactions, and (ii) why is the first type of FPHCI Transaction excluded?

In light of the tax consequences described above, we believe that the answer to the first question is that the provision is intended to make clear that the Hedging Regulations do not change the definition of a “hedge” for purposes of the exceptions to FPHCI characterization for gains and losses resulting from hedging transactions entered into in connection with the second and third types of FPHCI Transactions. Our understanding is, however, that the Hedging Regulations do apply to determine the character of gains or losses on “hedges” as defined in the Hedging Regulations, whether or not the transactions are also hedges under the subpart F regulations.¹³¹ A statement to that effect in the preamble to the final regulations would be helpful.

¹³¹ Moreover, we believe these character considerations remain relevant in the context of all three types of FPHCI Transactions.

We agree with the apparent policy decision of the regulation drafters to carve-out the subpart F hedging definitions from the Hedging Regulations for the limited purpose described in the preceding paragraph. We have not here undertaken a detailed review of the merits of the current hedging regime under subpart F,¹³² but it seems reasonable to clarify that regulations intended to address character should not affect the scope of the hedging exceptions to subpart F. With respect to the second question posed above however, we do not see any policy reason supporting exclusion from the carve-out for hedges entered into in connection with the first type of FPHCI Transaction described above. If it was intended that the Hedging Regulations affect the scope of the hedging exception to subpart F income for hedges entered into in connection with the first type of FPHCI Transaction, the Preamble should articulate the basis for the distinction among the different types of transactions. If this was not the intent, the carve-out should be broadened.

C. Interest Allocation Rules

Section 864(e) provides in part that interest expense is allocated and apportioned on the basis of the assets, not the gross income, of the taxpayer, and that the taxable income of

¹³² We do note that taxpayers may be able to manipulate the current rules by including hedging loss in the calculation of FPHCI while excluding the gain on the underlying active business transaction. If a forward contract, futures contract, option or similar instrument does not meet the requirements described above for the hedging exclusions from FPHCI, it is classified as property that does not give rise to any income and, as such, losses with respect to such property are includible in the calculation of FPHCI. Temp. Reg. § 1.954-2T(e)(5). Moreover, even if the inclusion of such losses were neutralized by the operation of the Regulations' character rules and the capital loss limitation of section 1211, such losses would reduce earnings and profits. See Section 312(f)(1) (allowing decreases in earnings and profits only for losses that are recognized), and Section 1211 (providing that excess capital losses are not allowed, but not providing that they are not recognized). This reduction in earnings and profits could have the same

each member of an affiliated group is determined by allocating and apportioning the interest expense of each member as if all members were a single corporation. The effect of this provision in many cases is to cause interest expense that might otherwise reduce U.S. source income to instead reduce foreign source income. The reduction of a U.S. affiliated group's foreign source income can, in turn, reduce its available foreign tax credits.¹³³

With one significant exception, the regulations apply these same rules to losses on financial products used to hedge interest rate risk and certain other financial products that are entered into in connection with, and are used to alter the effective cost of, a borrowing by a taxpayer that is not a financial services entity.¹³⁴ Gain on such a financial product, however, may not reduce such a taxpayer's total interest expense that is subject to apportionment unless the financial product is identified as a liability hedge in the manner prescribed in the regulations.¹³⁵

Treasury Regulation section 1.861-9T(b)(6)(iv)(C) prescribes the manner in which such identification must be made. The Hedging Regulations provide that the section 1221 definition of a hedging transaction does not apply for purposes of Temporary Regulation section 1.861-9T(b)(6)(iv)(C).

As stated above, losses on financial products that alter the effective cost of a borrowing are generally allocated and apportioned in a manner similar to interest, with one significant

effect as a direct reduction of FPHCI. See Section 952(c)(1) (generally limiting subpart F inclusions to current earnings and profits).

¹³³ See Section 904.

¹³⁴ Temp. Reg. § 1.861-9T(b)(6)(iv)(A).

¹³⁵ Temp. Reg. § 1.861-9T(b)(6)(iv)(B).

exception. Under that exception, if a taxpayer clearly identifies a financial product as a hedge of an interest-bearing asset, it will create a rebuttable presumption that the financial product is not one to which the interest allocation rules apply.¹³⁶ Thus, the apparent effect of the carve-out in the Hedging Regulations is to make clear that a hedge need not meet the relatively narrow definition of a hedge provided in the Hedging Regulations for it to qualify for the rebuttable presumption that the interest presumption that the interest allocation rules do not apply to it.

We have no objection to the carve-out if this is, indeed, its intended effect. Because the intended effect of carve-out is not stated, however, we are left with doubts about its purpose. If it is meant to do no more than is described above, a statement to that effect in the preamble to the final regulations would be helpful.

¹³⁶ Temp. Reg. § 1.861-9T(b)(6)(iv)(C).