REPORT #876

TAX SECTION

New York State Bar Association

Letter on Hedging Rules

Table of Contents

Cover Letter: i

I. Description of Problem.. ii

II. Separate-Entity Election Solves Problem, but Eligibility Not Always Clear v

III. Recommendations.. vi

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TAX SECTION
New York State Bar Association

May 14, 1996

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

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

Re: Coordination of Section 475 and
Hedging Rules for Consolidated Groups

Dear Secretary Samuels and Commissioner Richardson:

We are writing to bring to your attention a problem that arises under current law in the interaction of section 475 and the hedging regulations applicable to consolidated groups (Treas. Reg. §§ 1.446-4(e) and 1.1221- 2(d)), and to recommend that you address the problem by issuing guidance to coordinate these two sets of rules. Your request for comments in the preamble to the proposed version of the consolidated hedging regulations suggests that you are considering such guidance. The preamble states:

> The IRS intends to issue guidance under section 475 of the Code to coordinate the hedging exception of section 475(b)(1)(C) with these rules. In particular, if a consolidated group has not made a separate- entity election, the IRS is considering whether the identification of a hedging transaction by a member subject to section 475 should generally be sufficient to identify the transaction as a hedge under section 475(b)(1)(C), provided the hedged items are not securities subject to section 475(a). In this case, gain or loss on the hedging transaction would generally be subject to the timing rules of section

1.446-4 rather than to mark-to-market treatment under section 475.

Comments are requested on this matter.

1994-2 C.B. 865.

This letter responds to that request for comments and makes the following points:

(1) In the absence of guidance, section 475, the consolidated hedging regulations, and the intercompany transaction rules (Treas. Reg. § 1.1502-13) may interact to overtax or undertax a consolidated group in which a member subject to section 475 hedges risks of another member. If such a group does not make the separate-entity election permitted by Treas. Reg. § 1.1221-2(d)(2), the group may be required to recognize gain for tax purposes where no economic gain exists or to recognize loss where no economic loss exists. This result is inconsistent with the purpose of the singles-entity approach in Treas. Reg. § 1.1221 -2(d)(1), which is to treat members as if they were divisions of a single corporation.

(2) Overtaxation or undertaxation could be avoided if a group makes the separate-entity election under Treas. Reg. § 1.1221-2(d)(2) and consistently uses “back-to-back” intercompany hedges, but in many cases it is not clear whether a group is eligible to make the election. In any event, we do not believe that taxpayers should be forced to make the separate-entity election and consistently use “back-to-back” hedges to avoid overtaxation or undertaxation.

(3) Guidance coordinating section 475 with the consolidated hedging regulations should provide that the timing of gain or loss of a member subject to section 475 on a position that hedges an ordinary asset or liability of another member is matched, under Treas. Reg. § 1.446-4, with the timing of gain or loss from that asset or liability.

I. Description of Problem

It is common for one member (the “hedging member”) of a consolidated group to enter into transactions with unrelated parties to hedge the business risks of another member of the group (the “operating member”), with or without a “back-to-back” intercompany hedge. If the hedging member is required to “mark to market” its position with the unrelated party under section 475, the resulting gain or loss is taken into account immediately. Treasury Reg. § 1.446-4, which generally requires realized gain or loss from hedging transactions to be matched with gain or loss from the hedged position, does not apply to any position to which section 475 applies. See Treas. Reg. § 1,446-4(a)(2)(i). Thus, the essence of the problem is that the group is required to take into account immediately gain or loss on a hedge that corresponds to unrealized gain or loss (or reduced or increased future expense) on the hedged position.

Even if the hedging member’s transaction with the unrelated party qualifies as a hedging transaction under Treas. Reg. § 1.1221-2 and Treas. Reg. § 1.446-4, because it reduces the operating company’s risk, it would not qualify as a hedge under section 475(b)(1)(C). A position is a hedge for purposes of section 475 only if it reduces “the dealer’s risk of interest rate or price changes or currency fluctuations ....” Section 475(c)(3) (emphasis added). Thus, section 475(c)(3) does not adopt the single-entity approach of Treas. Reg. § 1.1221 -2(d)(]) and Treas. Reg. § 1.446-4(e)(9).

The results are the same if the two members enter into a “back-to- back” intercompany hedging transaction, in addition to the hedge with the unrelated party. In that case, the member subject to section 475 “marks to market” its transaction with the unrelated party and its side of the intercompany transaction, and, if the group does not make the separate- entity election under Treas. Reg. § 1.1221-2(d)(2), the other member in effect also “marks to market” its side of the transaction under Treas. Reg. § 1.1502-13(g)(3). See Treas. Reg. § 1.1502-13(g)(5) Example (5)(c). Thus, the hedging member’s gain or loss from the intercompany transaction is offset by the operating member’s gain or loss, leaving the group in the same position from the standpoint of timing as if there had been no intercompany transaction. Treasury Reg. § 1.446-4 would not apply to defer the operating member’s gain or loss on the intercompany transaction, because it would not be considered to be a “hedging transaction” within the meaning of Treas. Reg. § 1.1221-2 and Treas. Reg. § 1.446-4. See Treas. Reg. § 1.1221-2(d)(1).

The following example illustrates that a group that does not make the separate-entity election can be overtaxed under current law.

Parent owns 100% of the stock of Subsidiary. Assume that Parent and Subsidiary file consolidated returns but do not make the separate-entity election provided by Treas. Reg. § 1.1221-2(d). Subsidiary holds ordinary assets. In order to hedge against its risk of loss with respect to those assets if interest rates rise, Subsidiary enters into a notional principal contract with Parent (the “S-P Swap”). Simultaneously, Parent enters into a second notional principal contract with identical terms with an unrelated party (the “P-U Swap”). Interest rates rise with the result that Subsidiary has gain, and Parent has loss, on the S-P Swap. In addition, Parent has gain on the P-U Swap. If Parent is considered a “dealer in securities” within the meaning of section 475(c)(1), Parent is required under section 475(a) to take into account both its gain on the P-U Swap and its corresponding loss on the S-P Swap. Under Treas. Reg. § 1.1502- 13(g)(3), Parent’s recognition of a loss on the S-P Swap results in a deemed termination of the S-P Swap and entry into a new swap. Thus, Subsidiary is required to recognize its gain on the S-P Swap. The S-P Swap would not be treated as a hedging transaction within the meaning of Treas. Reg. § 1.1221-2. Thus, Treas. Reg. § 1.446-4 would not apply to defer Subsidiary’s gain on the S-P Swap and match it with the unrealized loss on Subsidiary’s ordinary assets. Accordingly, Parent and Subsidiary together would be required to report two gains and one loss, even though the two corporations together have no economic gain or loss.

The situation in the foregoing example could instead result in undertaxation of the group. If interest rates fall, the group would report two losses and one gain, and the unrealized gain on Subsidiary’s ordinary assets would not be taken into account. The straddle rules of section 1092 apparently would not require Subsidiary to defer its realized loss on the S-P Swap, because that swap would be a hedging transaction within the meaning of sections 1092(e) and 1256(e). Those sections do not adopt the single-entity approach of Treas. Reg. § 1.1221 -2(d)(1) and Treas. Reg. § 1.446- 4(e)(9)(i).

Thus, the apparent interaction of section 475 and the consolidated hedging rules may produce results that are neutral <u>ex ante</u>, in that undertaxation and overtaxation are equally likely. But <u>ex ante</u> neutrality is not an adequate answer for taxpayers that enter into hedging transactions to eliminate risk, and the prospect of overtaxation and undertaxation of individual taxpayers also should be unacceptable to the government.

II. Separate-Entity Election Solves Problem, but Eligibility Not Always Clear

A consolidated group could avoid the overtaxation or undertaxation described above by making the separate-entity election provided by Treas. Reg. § 1.1221-2(d)(2) and consistently entering into "back-to-back" intercompany hedges. In that case, the operating member's side of the intercompany transaction generally would qualify as a "hedging transaction" if the hedging member marks to market the intercompany transaction under such member's method of accounting. Any gain or loss realized by the operating member with respect to that transaction thus would be deferred and matched with gain or loss on its hedged position. See Treas. Reg. § 1.446-4(e)(9)(ii).

In many cases, however, it is not clear whether the hedging member is eligible to mark to market the intercompany transaction under its method of accounting. In general, whether the member uses mark-to-market accounting depends on whether the member is a dealer subject to section 475. The determination of whether a taxpayer is a dealer is factual. A taxpayer is a dealer if it regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. See section 475(c)(1). Whether a taxpayer is transacting business with customers is determined on the basis of all of the facts and circumstances. See Prop. Treas. Reg. § 1.475(c)-1(c). The hedging member may be treated as a dealer based solely on its intercompany transactions, provided that it holds itself out as being willing and able to enter into, and in fact does enter into, either side of contracts with members of its consolidated group. See Notice 96-12 (February 20, 1996). Thus, for example, a parent may be treated as a dealer if it stands ready to enter into, and in fact does enter into, either the fixed side or the floating side of fixed-for-floating interest rate swap contracts with its subsidiaries.

If the hedging member is confident that it is a dealer within the meaning of section 475, it can make the separate-entity election, consistently enter into "back-to-back" intercompany hedges and avoid the risk of overtaxation or undertaxation. If the hedging member is confident that it is not a dealer within the meaning of section 475, it will be confident that its positions will not be marked to market, and overtaxation or undertaxation should not arise.

However, it is quite common for a hedging member's transactions with operating members and with operating members and with unrelated persons to be sufficiently sporadic that the hedging member cannot be confident as to its dealer status. In such circumstances, if the group elects separate-entity treatment in order to avoid the overtaxation or undertaxation described in this letter and is determined to have been ineligible to treat the intercompany transaction as a hedging transaction (because the hedging member is not a dealer), Treas. Reg. § 1.1221-2(f)(1) apparently would create a character mismatch by treating one member's gain as ordinary and the other member's loss as capital. See Treas. Reg.
§ 1.1221 -2(f)(3)(ii).

Even if all taxpayers could be confident as to their status as dealers within the meaning of section 475, there does not seem to be any policy reason to force taxpayers that qualify as dealers to make the separate-entity election and consistently enter into "back-to-back" intercompany hedges to avoid overtaxation or undertaxation.

III. Recommendations

Accordingly, we recommend that the Treasury Department and Internal Revenue Service issue regulations to prevent overtaxation and undertaxation of consolidated groups in which the hedging member is a dealer but that do not make the separate-entity election. Such regulations might be issued under section 475 and provide that any transaction entered into by a taxpayer that meets the definition of a "hedging transaction" in Treas. Reg. § 1.1221-2 will also be considered to be a "hedge" within the meaning of section 475(b)(1)(C). Such regulations would provide that identification of a transaction as a hedging transaction for purposes of Treas. Reg. § 1.1221-2 is also treated as an identification for purposes of section 475(b)(2). Under such regulations, a hedging member could enter into a transaction with an unrelated party to hedge an operating member's risk, identify the transaction as a hedging transaction, not make the separate- entity election, and avoid mark-to-market accounting for that unrelated party transaction in the event that the hedging member is considered a dealer. Instead, under Treas. Reg. § 1.446-4, the timing of gain or loss from the unrelated party transaction would be matched with the timing of gain or loss from the operating member's hedged position. If the regulations that we recommend are adopted, a consolidated group that is uncertain whether the hedging member will be considered a dealer would have no reason to attempt to avoid the risk of overtaxation by making the separate-entity election.

As always, we would be pleased to talk with you and your staffs about the issues discussed in this letter, and to work with you in developing guidance to address those issues.

Sincerely,

Richard L. Reinhold
Chair