NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

TEMPORARY TREASURY REGULATIONS SECTION 1.988-5T(a)(6)(ii)

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I. INTRODUCTION

This report[1] comments on the temporary and proposed regulations under Section 988(d) that were issued on September 5, 2012 and updated on September 14, 2012.[2] The Temporary Regulations replace rules, previously promulgated under Section 988(d), that were applicable to a taxpayer who "legs out" of an "integrated economic transaction" (to which we will refer as a "**988 Synthetic Debt Instrument**") that generally is composed of a debt instrument denominated in, or linked to, nonfunctional currency and a financial instrument, or a combination of financial instruments, that hedges the taxpayer's currency exposure under the debt instrument (to which financial instrument(s) we will refer collectively as the "**hedge**," and to each component of which we will refer as a "**hedge component**"). The Temporary Regulations generally follow the approach taken in the regulations they replace (the "**prior Regulations**") in deeming a taxpayer who legs out of a 988 Synthetic Debt Instrument to sell any components

[1] The principal author of this report is Michael Farber, with substantial assistance from Patrick Sigmon. Helpful comments were received from Peter J. Connors, Sam Dimon, Stephen B. Land, David S. Miller, Andrew W. Needham and Michael L. Schler. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Unless otherwise indicated, all "Section" references herein are to the Internal Revenue Code of 1986, as amended (the "**Code**") and the Treasury Regulations promulgated thereunder. Because the text of the proposed regulations generally is identical to that of the temporary regulations, for brevity we refer herein to both regulatory packages, collectively, as the "**Temporary Regulations**."

of the integrated transaction that the taxpayer continues to hold at their then fair market value, but expands on the prior Regulations by explicitly addressing circumstances where the taxpayer sells one but not all hedge components.

The preamble to the Temporary Regulations describes the motivation for their promulgation as follows:

> The Internal Revenue Service and the Department of the Treasury . . . have become aware that some taxpayers who are in a loss position with respect to a qualifying debt instrument that is part of a qualified hedging transaction are interpreting the legging-out rules of § 1.988-5(a)(6)(ii)(B) to permit the recognition of loss on the debt instrument without recognition of all of the corresponding gain on the hedging component of the transaction. Taxpayers claim to achieve this result by hedging nonfunctional currency debt instruments with multiple financial instruments and selectively disposing of less than all of these positions. Taxpayers take the position that § 1.988-5(a)(6)(ii)(B) triggers the entire loss in the qualifying debt instrument but not the gain in the remaining components of the hedging side of the integrated transaction. . . . The IRS and the Treasury believe that these results are inappropriate under the legging-out rules since the claimed loss is largely offset by unrealized gain on the remaining component of the hedging transaction.[3]

The preamble and the text of the Temporary Regulations (in Regulations Section 1.988-5T(a)(9)(iv), Example 11) provide the following example to illustrate the motivation for, and operation of, the rules set out in the Temporary Regulations: A taxpayer with the U.S. dollar as its functional currency issues a fixed-rate debt instrument denominated in a foreign currency and, on the same day, enters into two swap contracts, a foreign currency/dollar currency swap and a fixed-for-floating dollar interest rate swap, that economically result in the transformation of the fixed-rate, foreign currency borrowing into a synthetic floating-rate dollar

[3] T.D. 9598, 2012-38 I.R.B. 343, 343-44.

borrowing. At a time when the underlying foreign currency debt is in a "loss" position from the taxpayer's perspective (*i.e.*, generally, when it would cost the taxpayer more to repay the debt instrument, in dollar terms, than the dollar value of the borrowed currency at the time that it was borrowed), the taxpayer disposes of the interest rate swap and takes the position that the disposition of the interest rate swap allows it to treat the debt instrument as terminated for an amount equal to its fair market value on the date of disposition, and to claim a loss on that termination, without taking into account the offsetting gain on the taxpayer's remaining currency swap position.[4] We will refer to (i) the nonfunctional currency borrowing as the "**FX Debt**," (ii) the foreign currency/dollar swap as the "**Currency Swap**," (iii) the interest rate swap as the "**Rate Swap**" and (iv) the reporting position taken by taxpayers with respect to the tax consequences of the disposition of the Rate Swap as the "**targeted position**."

We believe the targeted position is inconsistent with the purposes of Section 988(d)[5] and the economic substance of the transaction. We further believe it is unlikely that a court would sustain the targeted position even under the prior Regulations.[6] Accordingly, although we do not agree that promulgation of the Temporary Regulations was strictly necessary to challenge the targeted position in future transactions, we appreciate the need for greater certainty in this

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[4] The transactions targeted by the Temporary Regulations are facilitated, economically, by the fact that while the debt instrument has an embedded "loss" from the taxpayer's perspective, the interest rate swap has no or minimal offsetting gain. This situation can arise where the embedded loss in the taxpayer's debt instrument is attributable to an increase in the dollar value of the debt instrument's denomination currency (which thus also results in embedded gain in the taxpayer's *currency swap* position), rather than to a decline in interest rates. That the termination of a simple dollar-denominated rate swap can cause a leg-out of a 988 Synthetic Debt Instrument is itself a curious result, the logic of which should be considered in the context of the broader issues we discuss in Parts I.A and II.

[5] *See* H.R. REP. NO. 99-841, at 665 (1986) (Conf. Rep.) ("The committee included this regulatory authority to provide certainty of tax treatment for foreign currency hedging transactions that are fast becoming commonplace (such as fully hedged foreign currency borrowings) and to insure that such a transaction is taxed in accordance with its economic substance.").

[6] A significant number of our members view the targeted position as frivolous.

complex area of the law. We therefore support the efforts by the Treasury Department ("**Treasury**") and the Internal Revenue Service to clarify and improve the integration rules of Section 988(d).

More broadly, we also question whether the approach taken by the Temporary Regulations (and by the prior Regulations) is optimal, particularly in light of (i) the meaningfully different approach to similar issues taken by Regulations Section 1.1275-6 and (ii) the potential for divergent tax treatment of economically identical transactions at the option of the taxpayer (or inadvertently by an unwary taxpayer) as a result of these differences. In general, we view the approach to leg-outs taken by Regulations Section 1.1275-6 as simpler and more consistent with economic reality. We therefore recommend that Treasury modify the Temporary Regulations to adopt that approach. While a more complex undertaking, we also recommend that Treasury give serious consideration to aligning the approaches taken by the two integration regimes more generally.

The remainder of this report proceeds in four Parts. Part II considers whether the Temporary Regulations were even necessary in order to prevent the targeted position. Part III considers the approach to legging out under the Temporary Regulations, and concludes that while a number of more modest revisions and clarifications would be helpful in any event, the two existing tax integration regimes will continue to permit elective tax treatment of otherwise similar transactions unless their approaches to integrations and leg-outs are brought into closer alignment. Part IV briefly discusses the regulations' proscription on the use of remaining positions in subsequent integrations. Part V discusses issues relating to Temporary Regulations Section 1.988-5T(a)(6)(ii)(F), which addresses the treatment of remaining positions upon a leg-out in certain circumstances. In concluding, this report offers a recommendation on the broader interaction and differences between these two integration regimes.

II. DID THE TARGETED TRANSACTIONS ACHIEVE THE INTENDED RESULT?

In this Part, we discuss whether the transactions described in Example 11 of the Temporary Regulations were properly integratable under the prior Regulations, and if so, whether the prior Regulations supported the targeted position. We conclude that they did not.

A. Eligibility for integration under prior Regulations

A threshold question is whether it is possible under Regulations Section 1.988-5(a) generally to integrate a debt instrument denominated in nonfunctional currency with both a currency swap into dollars[7] and a dollar interest rate swap.

Regulations Section 1.988-5(a)(4) defines a "§ 1.988-5(a) hedge" to mean a "spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap contract, similar financial instrument, or series or combination thereof, that when integrated with a qualifying debt instrument permits the calculation of a yield to maturity (under the principles of section 1272) in the currency in which the synthetic debt instrument is denominated."[8] Moreover, Regulations Section 1.988-5(a) does not explicitly require that all or any of the hedge components manage currency risk. However, Section 988(d)(1) provides that, "[t]o the extent provided in regulations, if any section 988 transaction is part of a 988 hedging transaction, all transactions which are part of such 988 hedging transaction shall be integrated and treated as a single transaction

[7] For the sake of simplicity, we assume throughout this report that the taxpayer's functional currency is the dollar.

[8] Following the convention employed by existing Regulations Section 1.988-5(a), the term "**hedge**" as used herein refers to a "§ 1.988-5(a) hedge" (as defined in that Section), except where otherwise noted. Further, as used herein, "**QDI**" refers to a "qualifying debt instrument" as defined in Regulations Section 1.988-5(a)(3), except where otherwise noted.

or otherwise treated consistently for purposes of this subtitle," while Section 988(d)(2) defines a "988 hedging transaction" as a transaction "entered into by the taxpayer *primarily . . . to manage risk of currency fluctuations* . . . ."[9]

The Currency Swap clearly is a Section 988 transaction.[10] If the statutory requirement that a hedge must primarily manage currency risk were imported into the Regulations, and assuming that the "988 hedging transaction" in Example 11 is the combination of the Currency Swap and the Rate Swap, then the operative question is whether (and what metrics would govern whether) that combination *primarily* manages the taxpayer's currency risk under the FX Debt.[11] The regulations (proposed and existing) are silent on this question, including whether it is relevant to their applicability. Thus, it is not entirely clear to us that a strict reading of the statute permits the integration described in the preamble and in Example 11.[12]

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[9] Section 988(d) (emphasis supplied). As we noted in our 1992 comments to the Treasury in respect of the regulations originally finalized under Section 988(d), the scope of Regulations Section 1.988-5(a) appears significantly broader than this statutory authorization. NYSBA Tax Section Committee on Financial Instruments, *Report on Final and Proposed Section 988 Regulations*, Oct. 21, 1992 (published in Tax Notes International, Nov. 4, 1992).

[10] *See* Sections 988(c)(1)(A) ("The term 'section 988 transaction' means any transaction described in subparagraph (B) if the amount which the taxpayer is entitled to receive (or is required to pay) by reason of such transaction (i) is denominated in terms of a nonfunctional currency, or (ii) is determined by reference to the value of 1 or more nonfunctional currencies') and 988(c)(1)(B) ("For purposes of subparagraph (A), the following transactions are described in this paragraph . . . [e]ntering into or acquiring any forward contract, futures contract, option, or similar financial instrument."); Regulations Section 1.988-1(a)(2)(iii)(B)(2).

[11] Alternatively, some practitioners have argued that the Rate Swap should be eligible for integration only under Regulations Section 1.1275-6, if at all, and not under Regulations Section 1.988-5, even if the "hedge" of which it is a "component" primarily manages currency risk. *See Treasury Stops Abusive Foreign Currency Hedging Transactions*, 95 Tax Analysts Daily Tax Highlights 7005, 7005 (Sept. 6, 2012). We do not necessarily agree with this position, and in any case there is at least some uncertainty regarding whether the Rate Swap can be integrated with a 988 Synthetic Debt Instrument under Regulations Section 1.1275-6. *See infra* note 23 and accompanying text.

[12] A separate question raised by Example 11 is whether it is possible to integrate a "988 hedging transaction" with a nonfunctional currency debt instrument where the resulting synthetic debt instrument would be a "variable rate debt instrument" within the meaning of Regulations
(…continued)

B. Did the prior Regulations support the targeted position?

Assuming that the combination of the Currency Swap and the Rate Swap is properly integratable with the FX Debt under Regulations Section 1.988-5(a), we do not believe that the prior Regulations supported the targeted position, for the following reasons.

1. The prior Regulations did not require a deemed sale of the FX Debt.

Prior Regulations Section 1.988-5(a)(6)(ii) provided that a taxpayer "legs out" of integrated treatment if he or she, among other things, "disposes of or otherwise terminates *all or a part of* the qualifying debt instrument or hedge prior to the maturity of the qualified hedging transaction," which suggests that a disposition of less than all of the hedge would have triggered a leg-out. However, the prior Regulations deemed a disposition of the qualifying debt instrument to occur only if "the hedge" was disposed of or otherwise terminated, which literally does not happen until the taxpayer disposes of or terminates *all* hedge components. Thus, on a literal reading of the regulation, the taxpayer would not have been entitled to recognize any loss in respect of the FX Debt upon disposition of only the Rate Swap.

We do note, however, that if the disposition of the Rate Swap were determined not to have triggered a deemed disposition of the FX Debt, then the prior Regulations would not have provided for *any* consequences of a leg-out under circumstances where a hedge component is retained, which would not properly reflect the change in the taxpayer's underlying economic position. This may suggest the result was unintended.

(continued…)

Section 1.1275-5. Although an example in the existing regulations describes that result, *see* Regulations Section 1.988-5(a)(9)(iv), Example 9, the regulations do not explicitly authorize hedging into a variable rate debt instrument (as Regulations Section 1.1275-6(b)(2) does).

2. If the prior Regulations required a deemed sale of the FX debt, they may also have required a deemed sale of the Currency Swap.

Even assuming that the taxpayer's disposition of the Rate Swap did trigger a deemed disposition of the FX Debt under the prior Regulations, the prior Regulations may nonetheless have provided for a deemed sale of the Currency Swap (which on the facts of Example 11 would have resulted in the recognition of gain largely offsetting the loss recognized with respect to the QDI). While the prior Regulations' language did not explicitly provide for such a deemed sale of the Currency Swap, we think it clear that this was a drafting oversight rather than a deliberate choice. For example, the preamble to temporary regulations promulgated in 1989 indicates that those regulations simply did not contemplate the integration of a qualifying debt instrument with multiple hedging instruments capable of being unwound independently.[13] In any event, we believe that a termination of the Currency Swap position could be deemed to have occurred under the prior Regulations via a "recursive" application of the prior Regulations' rules for legging out: Under those rules, if the taxpayer sold or otherwise disposed of a portion of the hedge, the taxpayer was deemed to have sold the QDI on the leg-out date.[14] This deemed disposition of the QDI could, in turn, be read to have triggered prior Regulations Section 1.988-5(a)(6)(ii)(C), which provided for the deemed sale of the hedge upon the taxpayer's disposition or other termination of the QDI. This reading would achieve the apparent goal of the prior Regulations (*i.e.*, a "clearing of the tax slate" upon a leg-out), although it is perhaps not an unambiguously correct reading of the regulatory language.

[13] *See* T.D. 8265, 1989-2 C.B. 160 ("In such case, § 1.988-5T(a)(6)(ii) provides that gain or loss on *the instrument* that was not disposed of is realized and recognized at the time of legging out." (emphasis supplied)).

[14] S*ee* prior Regulations Section 1.988-5(a)(6)(ii)(B).

3. A "deemed sale" of a QDI does not affect its issuer.

Even if a termination of the Rate Swap triggered a deemed sale of the FX Debt (and/or the Currency Swap), the language of the prior Regulations did not provide for the recognition of any loss by the taxpayer with respect to the FX Debt. The rules for legging out deem the QDI to be "*sold* for its fair market value on the date the hedge is disposed of or otherwise terminated."[15] As a general principle of tax law, the sale of a debt instrument has no tax consequences for the *issuer* of the instrument. Therefore, under a literal reading of the Regulations (both prior and Temporary), the issuer of a QDI (such as the taxpayer in Example 11), if it continued to be the obligor on the QDI, would recognize *no* income or loss with respect to the QDI upon legging out of the integrated transaction.

While we believe this reading of the regulations is clearly correct, it does constitute something of a Pyrrhic victory. While, as discussed further below, we do not favor treating the QDI as sold or terminated upon a leg-out of a 988 Synthetic Debt Instrument, we do not believe that it is appropriate for the taxpayer upon a leg-out to recognize no income or loss with respect to *either* the synthetic debt instrument *or* the QDI. Thus, if our suggestion to conform the approach taken in the Temporary Regulations to that taken in Regulations Section 1.1275-6 is not adopted, then at a minimum the Temporary Regulations should be modified to provide that when a QDI issuer legs out of an integrated transaction but continues to be the obligor on the QDI, the issuer is deemed to repurchase and reissue the QDI for its then fair market value.[16] Moreover, we note that upon the

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[15] Regulations Section 1.988-5T(a)(6)(ii)(B) (emphasis supplied).

[16] *Cf.* Regulations Section 1.1275-6(d)(2)(ii)(B) (treating a taxpayer that legs out as selling "*or otherwise terminating*" the Regulations Section 1.1275-6 synthetic debt instrument). Of course, this deemed satisfaction and reissuance would be solely from the issuer's (that is, the integrating taxpayer's) perspective; neither the integration of a transaction nor its unwinding has any tax consequences to the counterparty or counterparties as such.

satisfaction of a debt instrument, the issuer may have exchange gain or loss, but it may also have cancellation of indebtedness income or repurchase premium, neither of which is addressed by the Regulations (Temporary or prior) at all.

4. The straddle rules may have applied.

Even if the disposition of the Rate Swap would under the prior Regulations have triggered a deemed sale of (and a realized loss with respect to) the FX Debt but no consequences with respect to the Currency Swap, it is possible that the loss deferral rules of Section 1092 (the "straddle rules") would nonetheless have prevented the taxpayer from recognizing all or a portion of the loss realized on the deemed sale of the FX Debt. Upon legging out of integrated treatment, the taxpayer holds offsetting positions with respect to nonfunctional currency (*i.e.*, the Currency Swap and the FX Debt).[17] In the absence of some rule to the contrary, the straddle rules would prevent the taxpayer from currently recognizing a currency loss on the FX Debt to the extent of unrecognized gain with respect to the Currency Swap.[18]

However, Section 988(d)(1) does provide that the straddle rules "shall not apply to a transaction covered by this subsection,"[19] and the regulations further

[17] *See* Section 1092(d)(7)(A) ("[A]n obligor's interest in a nonfunctional currency denominated debt obligation is treated as a position in the nonfunctional currency.").

[18] *See* Section 1092(a)(1)(A). Note that, in addition to currency loss, the taxpayer in Example 11 (as the issuer of the FX Debt) could realize repurchase premium on a deemed termination of the FX Debt. The straddle rules themselves would not prevent the taxpayer from taking any repurchase premium into account in the taxable year of the deemed termination, although it is possible that the taxpayer might be required to capitalize the repurchase premium under Section 263(g) or, more likely, the proposed regulations thereunder.

[19] Section 988(d)(1). *See also* H.R. REP. NO. 99-841, *supra* note 5, at 669 ("Neither the loss deferral rule of section 1092 nor the mark-to-market regime under section 1256 will apply to a section 988 transaction that is part of a hedging transaction and described in regulations to be issued under section 988 by the Secretary.").

provide that "[n]either the qualifying debt instrument nor the hedge that makes up the qualified hedging transaction shall be subject to section . . . 1092 . . . for the period such transactions are integrated."[20] While immediately after the taxpayer disposes of the Rate Swap, the FX Debt and the Currency Swap cease to be integrated and so could become subject to the straddle rules (including in respect of any loss realized on the sale of the FX Debt deemed to occur under the prior Regulations), the prior Regulations further specified that "any gain or loss [on the QDI] . . . from the identification date to the leg-out date is realized and *recognized* on the leg-out date."[21] Thus, it is not entirely clear to us whether the straddle rules would apply to require deferral (or capitalization) of any loss realized on a deemed disposition of the FX Debt.

For one or more of the reasons discussed in this Part II, we do not believe that the prior Regulations supported the targeted position.

III. THE TEMPORARY REGULATIONS' APPROACH TO THE PERCEIVED ISSUE

In this Part III, we discuss the substantive merits of the approach take by the Temporary Regulations to address the questions raised in the preamble.

Putting aside the questions discussed in Part I, the regulations under Section 988(d) historically have deemed, and the Temporary Regulations continue to deem, a taxpayer that legs out of a 988 Synthetic Debt Instrument to have sold

[20] Regulations Section 1.988-5(a)(9).

[21] Prior Regulations Section 1.988-5(a)(6)(ii)(B) (emphasis supplied). The Service has (in unpublished guidance) indicated that recognition of gain or loss is appropriate under the rules for legging into a "mixed straddle" in what could be considered analogous regulatory circumstances. *See* Field Service Advice 1999-664 (Vaughn # 441), July 30, 1993 ("The purpose of requiring a taxpayer to currently recognize pre-straddle gain or losses is to provide a clean slate for the computation of gains or losses while the mixed straddle is in place.").

its remaining instrument(s) (*i.e.*, the QDI or the hedge, as the case may be). In contrast, Regulations Section 1.1275-6 takes a very different approach to legging out: Under that section, the taxpayer is deemed (i) to terminate the synthetic debt instrument, (ii) to realize and recognize any gain or loss on that termination, subject to the application of any loss deferral rules applicable to the synthetic debt instrument and (iii) immediately thereafter either (A) to make appropriate adjustments to reflect any differences between the fair market value of the QDI and its adjusted issue price or (B) to (re-)enter into the 1.1275-6 hedge at its then fair market value, as the case may be. This divergence in approach raises a number of questions, some of which are beyond the scope of this report. However, at least in the context of transactions (such as those presented in Example 11 of the Temporary Regulations) in which the disposition of one component of a hedge leaves the taxpayer with a QDI that, economically, remains fully hedged into dollars, the rationale behind the approach taken in the Temporary Regulations is not clear to us. Temporary Regulations Section 1.988-5T(a)(6)(ii)(F) (discussed further in Part V below) perhaps mitigates the effects of this discrepancy between the two regimes to some degree (though not in a way that we find helpful, as we discuss below), but in any event only where the taxpayer is in a gain position with respect to the component(s) of the hedge that are unwound, a condition that does not necessarily have any economic relationship to the taxpayer's position with respect to nonfunctional currency. Although the approach taken in Regulations Section 1.1275-6 could itself be improved, as discussed further in note 30 below, in our view the Temporary Regulations should follow a similar approach with respect to the types of situation that apparently motivated their promulgation. Moreover, we believe Treasury should consider whether to pursue a broader alignment of the integration regimes under Sections 988 and 1275.

The starting point for our analysis is the observation that in Example 11, the taxpayer's position in nonfunctional currency is not affected by the taxpayer's disposition of the Rate Swap. It is unclear, then, why the taxpayer should recognize any exchange gain or loss upon that disposition. A better result, one more in line with the principles that underlie Section 988(d),[22] would deny current recognition of any loss inherent in the FX Debt by continuing the integrated treatment of the FX Debt and the Currency Swap. In other words, the taxpayer should be deemed to dispose of the 988 Synthetic Debt Instrument while continuing to be treated as having issued a fixed-rate synthetic debt instrument denominated in dollars, subject to any appropriate adjustments due to differences between the fair market value of that synthetic dollar borrowing and its adjusted issue price. Modifying the Temporary Regulations in this manner to be more consistent with the integration regime in Regulations Section 1.1275-6 would result in tax consequences that more accurately reflect the taxpayer's economic position.

Perhaps more problematic than this disconnect between the taxpayer's economic position and the consequences of legging out prescribed by the Temporary Regulations, the approach taken by the Temporary Regulations effectively allows taxpayers to elect the manner in which they will be taxed (albeit on a prospective basis). In Example 11 of the Temporary Regulations, if the taxpayer had chosen first to integrate the FX Debt with the Currency Swap under Regulations Section 1.988-5 and then "serially" to integrate the resulting synthetic debt instrument with the Rate Swap under Section 1.1275-6,[23] a later

[22] *See* H.R. REP. NO. 99-841, *supra* note 5, at 665 ("The committee included this regulatory authority to provide certainty of tax treatment for foreign currency hedging transactions that are fast becoming commonplace (such as fully hedged foreign currency borrowings) and to insure that such a transaction is taxed in accordance with its economic substance.").

[23] In general, from the perspective of the taxpayer that holds (or is the obligor with respect to) it, a 988 Synthetic Debt Instrument is treated as debt for all purposes of the Code. Thus, presumably, a 988 Synthetic Debt Instrument is also a Regulations Section 1.1275-6 QDI, even if (…continued)

disposition of the Rate Swap would have had very different consequences from those provided for in the Temporary Regulations, because that leg-out would have been governed by Regulations Section 1.1275-6. In that case, the taxpayer would have been deemed to dispose of its Regulations Section 1.1275-6 synthetic debt instrument, while its 988 Synthetic Debt Instrument would have continued to be treated as an integrated transaction, subject to proper adjustments to reflect the difference between its then fair market value and its adjusted issue price.[24]

There is a further question whether the combination of the FX Debt, the Currency Swap and the Rate Swap could have been integrated in one "unitary" integration under Regulations Section 1.1275-6. Although a nonfunctional currency denominated debt instrument can be a Regulations Section 1.1275-6 QDI,[25] "a financial instrument that hedges currency risk is not a § 1.1275-6 hedge,"[26] which might appear to preclude the taxpayer in Example 11 from simultaneously integrating all three instruments under the 1.1275-6 rules.

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not affirmatively defined as such (as Regulations Section 1.1275-6 synthetic debt instruments are). *See* Regulations Section 1.1275-6(b)(1). However, the explicit inclusion of a previously integrated Regulations Section 1.1275-6 synthetic debt instrument in the definition of a Regulations Section 1.1275-6 QDI could conceivably be read to suggest that a 988 Synthetic Debt Instrument was intended to be excluded from that definition. If so, the taxpayer could not integrate the Rate Swap with the 988 Synthetic Debt Instrument as described above, which in our view would be an inappropriate result under Regulations Section 1.1275-6.

[24] Note, however, that in this scenario, had the taxpayer instead disposed of the *Currency* Swap, the result would be somewhat unclear. This is because the taxpayer would be simultaneously legging out of two separate integrations, one done under Regulations Section 1.988-5 and the other done under Regulations Section 1.1275-6. As discussed throughout this report, those regimes can provide for different and inconsistent consequences. So, for example, Regulations Section 1275-6 would require the taxpayer to make adjustments to its remaining issued debt to account for its fair value/adjusted issue price differential, whereas Regulations Section 1.988-5 would instead (subject to the discussion in Part II.B.3) treat the taxpayer as terminating the issued debt instrument.

[25] *See* Regulations Section 1.1275-6(h), Example 3.

[26] Regulations Section 1.1275-6(b)(2)(i). For this purpose, Regulations Section 1.1275-6(b)(3) defines a "financial instrument" to include "a combination or series of financial instruments."

However, we believe that conclusion should be resisted, as it has potentially troublesome consequences. For example, suppose that a taxpayer (i) issues a two-year, $100 debt instrument that provides for a payment equal to $100 x (1 + Index Performance) at maturity (and no other payments), where Index Performance is the greater of zero and the percentage change in the closing level of the Tokyo Stock Price Index (or "TOPIX") from the issue date of the debt instrument to its maturity date, and (ii) enters into a bullet swap under the terms of which the taxpayer agrees to pay $10 in two years in return for the right to receive at that time a payment in the amount of $100 x Index Performance. Disregarding the credit risk of the swap counterparty, the taxpayer is in the same position it would have been in had it issued a zero-coupon dollar debt instrument with original issue discount; these transactions should, normatively, be eligible for integration. However, the bullet swap clearly manages the taxpayer's currency risk insofar as the closing level of TOPIX is, in part, a function of the value of the Japanese yen; thus, it may be that, read literally, Regulations Section 1.1275-6 cannot apply to these transactions. If that were the case, then unless one concluded that the taxpayer entered the bullet swap *primarily* to manage the taxpayer's exposure to fluctuations in the value of Japanese yen (which would on its face appear to be quite a stretch), so that the transactions could be integrated under Regulations Section 1.988-5, these transactions might not be eligible for integration at all. We do not believe this is the intended or the correct result, and we see no reason why these transactions should not be integratable under Regulations Section 1.1275-6. We similarly see no reason why the transactions described in Example 11 should not be integratable under that Section.[27]

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[27] Presumably, the idea behind this limitation was that hedges of currency risk should be dealt with in Section 988 and Regulations Section 988-5. First, as the example in the text illustrates, there are fact patterns in which this black-or-white approach is not realistic. Second, as this report emphasizes throughout, the conceptual underpinning of this limitation, namely that under which Section one integrates (including in some cases by choice) "matters," is, we think, misguided – the essential tax consequences should be the same without regard to the regime(s) under which the taxpayer chooses to integrate.

Assuming this is correct, then the transactions described in Example 11 could conceivably be integrated in at least three different ways: (1) as a "unitary" integration under Regulations Section 1.988-5;[28] (2) as a "serial" integration the first leg of which is done under Regulations Section 1.988-5 and the second leg of which is done under Regulation Section 1.1275-6;[29] and (3) as a "unitary" integration under Regulations Section 1.1275-6.[30] Each of these integrations can,

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[28] This is how Example 11 assumes the transactions were integrated.

[29] This is the integration discussed in note 11.

[30] Note that the transactions in Example 11 could not be "serially" integrated under Regulations Section 1.1275-6 alone, because in that event the first-leg integration would necessarily involve solely a currency hedge, which is not a permissible hedge under Regulations Section 1.1275-6. But note that there are fact patterns in which this is possible, and in those cases Regulations Section 1.1275-6 itself appears to generate divergent results, depending on whether the taxpayer (a) serially integrates a collection of instruments or (b) integrates those same instruments at once. To take an example unrelated to foreign currency, consider a taxpayer integrating a fixed-rate dollar debt instrument with two interest rate swaps, Swap A and Swap B, where the debt instrument also could, under the Regulations Section 1.1275-6 rules, properly be integrated with Swap A alone. (Putting aside why one might want to do this, an example might be a fixed-to-LIBOR swap and a LIBOR-to-prime swap.) The taxpayer could first identify the debt instrument and Swap A as a Regulations Section 1.1275-6 synthetic debt instrument ("synthetic X"), and thereafter identify synthetic X and Swap B as a second Regulations Section 1.1275-6 synthetic debt instrument ("synthetic Y"). Alternatively, the taxpayer could identify the debt instrument and the combination of Swaps A and B as a "unitary" Regulations Section 1.1275-6 synthetic debt instrument ("synthetic Z"). If the taxpayer later disposes of Swap B, the Regulations Sections 1.1275-6 rules would appear, at least as a technical matter, to result in different tax consequences depending on which way the integration was done: In the "serial integration" case, the taxpayer would be deemed to terminate synthetic Y, and proper adjustments would be made to synthetic X, which would "survive" the leg-out. In the "unitary integration" case, the taxpayer would be deemed to terminate synthetic Z, would be treated as entering into Swap A at its then fair market value, and would be required to make proper adjustments to the original underlying dollar debt. *See* Regulations Section 1.1275-6(d)(2)(ii)(C). Thus, Regulations Section 1.1275-6 is not without its own opportunities for taxpayer mischief and traps for the unwary. We see no reason why the results should not be the same in these cases, however the integration is done. In general, we think that if what remains is a qualifying synthetic debt instrument, whether under Regulations Sections 1.988-5 or 1.1275-6, then it should "survive" as such. (Note that to achieve this result, it would be helpful if the regulations provided that any "unitary" integration identification is deemed to include any possible "sub-integration" identification(s), so that each potential synthetic debt instrument remaining upon a leg-out is deemed to have been properly identified.)

Nor could the transactions in Example 11 be serially integrated with the first leg done under Regulations Section 1.1275-6 and the second done under Regulations Section 1.988-5, for
(…continued)

we think, lead to different results upon legging out.[31] We do not believe that different conceptual frameworks should apply to virtually identical economic transactions, with potentially significantly different tax consequences that depend solely on how the taxpayer chooses to effect their integration (and/or their unwinding).

IV. USE OF REMAINING POSITIONS IN A LATER INTEGRATION

Another area where the Temporary Regulations diverge from Regulations Section 1.1275-6 is in their treatment of instruments retained by the taxpayer after legging out of an integrated transaction. Regulations Section 1.988-5T(a)(6)(ii)(E) prohibits the taxpayer from ever using such instruments as the basis for a future integration under Section 988(d),[32] whereas Regulations Section 1.1275-6 generally requires only that the taxpayer wait thirty days.[33] Again, the policy rationale for this distinction is unclear. Indeed, given that the current formulation of the rules for legging out of a 988 Synthetic Debt Instrument effectively requires that the underlying QDI and each hedge component be "marked to market," the policy case for disallowing future integration appears even less

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(continued…)

the same reason as in the prior paragraph. However, there do exist collections of transactions that could be integrated in this latter manner. For example, a floating-rate pound swap could be integrated with a pound floating-for-fixed interest rate swap under Regulations Section 1.1275-6, and the resulting fixed-rate pound synthetic could then be integrated into dollars under Regulations Section 1.988-5.

[31] The complexity increases significantly when one considers the various ways in which these integrations can be unwound. As has been touched on, even once a choice of regime(s) has been made, taxpayers may in many cases have differing tax consequences depending on the order in which their hedges are unwound. *See supra* note 24 and accompanying text.

[32] Prior Regulations Section 1.988-5(a)(6)(ii)(D) included the same prohibition. The Commissioner, on the other hand, is not so limited and can force integration on the taxpayer under certain circumstances. *See* Regulations Section 1.988-5T(a)(6)(ii)(E); Regulations Section 1.988-5(a)(8)(iii).

[33] *See* Regulations Section 1.1275-6(c)(1)(iv).

obvious than under Regulations Section 1.1275-6. We see no reason why there should be any limitation on re-integration in Regulations Section 1.988-5 as it currently exists, and if that Section is modified to conform to the approach to legging out taken by Regulations Section 1.1275-6, we believe the 30-day limitation on re-integration is appropriate.[34]

V. ISSUES REGARDING TEMPORARY REGULATIONS SECTION 1.988-5T(A)(6)(II)(F)

Regulations Section 1.988-5T(a)(6)(ii)(F) provides an exception to the general rule that, if a taxpayer legs out of a 988 Synthetic Debt Instrument, the remaining components of the synthetic debt instrument are deemed to be sold on that date. However, that Section applies only if the taxpayer recognizes a gain with respect to the component that was actually sold or otherwise terminated. Again, the policy basis for this distinction is not clear and, as demonstrated by Example 11 of the Temporary Regulations, this provision may result in meaningfully different tax consequences on the basis of immaterial factual differences (*e.g.*, whether the Rate Swap, which is wholly unrelated to currency fluctuations and therefore to the amount of unrealized gain in the Currency Swap, is sold at a gain of $0.01 or at a loss of $0.01).

Moreover, if our recommendation to modify the Temporary Regulations to conform to the approach of Regulations Section 1.1275-6 is adopted, Regulations Section 1.988-5T(a)(6)(ii)(F) would be rendered unnecessary. Indeed, we think that eliminating this complex provision is itself an independent reason to adopt the approach of Regulations Section 1.1275-6 in Regulations Section 1.988-5.

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[34] *Cf.* Section 1091(a) (disallowing deductions where certain transactions occur within 30 days of the transaction that would otherwise generate the deduction).

Putting aside the question of whether Regulations Section 1.988-5T(a)(6)(ii)(F) is necessary and, if so, whether it should be expanded to cover situations where the taxpayer recognizes a loss in respect of the instrument that is sold or otherwise terminated, that Section appears to be incomplete, in that it does not provide any guidance regarding the treatment of the taxpayer's remaining instruments in circumstances where it applies. If the Section applies because, for example, the Rate Swap in Example 11 is terminated at a gain, are the FX Debt and the Currency Swap treated as a continuing synthetic debt instrument, and if so, are any adjustments made to reflect the difference between the fair market value of that synthetic debt instrument and its adjusted issue price, as would be the case under Regulations Section 1.1275-6?[35] If not, is the taxpayer deemed to enter into the Currency Swap at its fair market value, and are any adjustments made to the FX Debt? In short, Regulations Section 1.988-5T(a)(6)(ii)(F) tells the taxpayer how it will *not* be treated, but it gives no guidance as to how the taxpayer *will* be treated.

In addition, it is not clear what it means to hedge "at least 50% of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction."[36] In particular, to what does "currency flow" refer? Does it refer to the number of payments called for under the QDI? To the magnitude of the currency component of each payment? What, for example, is the "currency flow" on the TOPIX-linked instrument described in Part III above? Even in situations where currency fluctuations may be easily separated

[35] If the arrangements in Example 11 are so treated, what would happen if instead the taxpayer was left with a "proportionately hedged" debt instrument, as the Regulation permits? Would the portion of the QDI that was no longer hedged be deemed sold (or terminated)? The portion of the synthetic debt instrument corresponding to the unhedged portion of the QDI? Neither? What if the remaining instruments hedged more than 50% of the "currency flow" on the QDI, but not in a way that lent itself to characterization as a synthetic debt instrument?

[36] Regulations Section 1.988-5T(a)(6)(ii)(F).

from changes in value due to factors other than currency exchange rates, will it invariably be possible to know on the leg-out date whether 50% of the "currency flow" is hedged? Consider a situation in which a taxpayer (i) issues a 30-year nonfunctional currency denominated debt instrument calling for quarterly interest payments at a floating interest rate and (ii) hedges the interest payments by entering into one notional principal contract and the principal amount by entering into a separate instrument. If the taxpayer legs out after two years by selling the second instrument, how would the taxpayer determine whether 50% of the remaining currency flow is hedged, given that it would be impossible to know on the leg-out date the magnitude of future foreign currency payments on the QDI?

Once again, these uncertainties demonstrate some of the complexity caused by the approach taken in Regulations Section 1.988-5 as compared with that taken in Regulations Section 1.1275-6.

Conclusion

The two existing tax integration regimes take very different approaches to legging out of an integrated transaction. Although there are a number of other respects in which the two regimes diverge, many or most of these differences do not address concerns related to the economic characteristics of currency-linked as opposed to non-currency-linked instruments. As we have attempted to demonstrate in this report, the danger posed by these inconsistencies is magnified by the multitude of ways in which the two regimes can be exploited to achieve different tax consequences based solely on how taxpayers effect integrations and leg-outs involving multi-position hedges. We believe that the two regimes should be aligned to provide substantially identical results under these circumstances, regardless of how an integration is effected or unwound, except where it is determined that currency considerations dictate that there should be differences.

Our narrow recommendation in this regard is that Regulations Section 1.988-5T(a)(6)(ii) be further amended to provide that upon a leg-out, the taxpayer is deemed to have disposed of or terminated its ***synthetic*** debt instrument, and is required to make adjustments to its remaining positions, in the same manner that Regulations Section 1.1275-6 currently operates. Ideally, the amended regulations would permit any remaining positions that themselves constitute a synthetic debt instrument (or would have so constituted, had a standalone identification been made for them) thereafter to be so treated. If this recommendation is adopted, then Regulations Section 1.988-5T(a)(6)(ii)(F) could be eliminated. In any event, we think Regulations Section 1.988-5T(a)(6)(ii)(E) should be revised to prohibit subsequent integrations only for 30 days following a leg-out, as Regulations Section 1.1275-6 does.

More broadly, we believe consideration should be given to aligning the regimes in Regulations Sections 1.988-5 and 1.1275-6, both to make clear under what circumstances each regime applies, particularly in the context of multi-hedge and "serial" integrations, and also to minimize or eliminate the differences in tax consequences that can result from the various permutations under which integrations can be accomplished and unwound under current law. At a minimum, a robust set of "ordering" rules would go a long way towards improving the current state of the law in this area. We would be happy to assist in this undertaking, including drafting a more detailed report on the ways in which these regimes could be aligned and the issues that would arise.