INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 17, 2004

Third Party Communication: None
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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Month =

Year 1 =

Year 2 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

ISSUES:

(1) Whether the losses resulting from Taxpayer's liability hedging transactions are capital pursuant to section 1.1221-2 of the Treasury Regulations?

(2) Whether Taxpayer's recognition of the hedging losses in Year 1 clearly reflects income?

CONCLUSIONS:

(1) The losses resulting from Taxpayer's Original Swaps are capital.

(2) Taxpayer's recognition of the hedging losses in Year 1 clearly reflects income.

FACTS:

On Date 1, Taxpayer incurred $a of floating-rate debt from a consortium of b banks ("floating-rate debt"). The debt had a term of c years. On Date 2, Taxpayer entered into c-year interest rate swaps with d banks ("Original Swaps"). The aggregate notional principal amount of the swaps at inception was $a and was amortized on the same schedule as the principal amortization of the floating-rate debt. Under the Original Swaps, Taxpayer received LIBOR-based periodic payments in exchange for fixed-rate periodic payments. Taxpayer entered into the Original Swaps to reduce its risk of interest rate changes with respect to the floating-rate debt. The Original Swaps, however, were not identified as hedging transactions on Taxpayer's books and records.

On Date 3, Taxpayer retired the floating-rate debt with the proceeds from the issuance of e series of fixed-rate senior notes due in Year 2 ("fixed-rate notes"). The fixed-rate notes were offered in a private placement, and the aggregate principal amount of the notes was approximately $f. Also on Date 3, Taxpayer entered into offsetting interest rate swaps with g of the d bank counterparties to the Original Swaps and an offsetting interest rate swap with a new bank counterparty (collectively the "Offset Swaps"). Under these Offset Swaps, Taxpayer received fixed-rate periodic payments in exchange for LIBOR-based periodic payments through Month of Year 2. The combination of payments between the Original Swaps and the Offset Swaps locked in the fixed payments on the swaps. Taxpayer identified the Offset Swaps as hedging transactions on its books and records; however, it is unclear what these transactions were hedging. Taxpayer did not dispose of the Original Swaps when it retired the floating-rate debt.

On Date 4, Taxpayer terminated all of the Original Swaps and g of the d Offset Swaps. In connection with the termination of the Original Swaps, Taxpayer entered into new interest rate swaps for a term of h years with the same counterparties to the Original Swaps ("New Pay-Fixed Swaps"). In connection with the termination of the Offset Swaps, Taxpayer entered into new interest rate swaps for a term of i years with g of the d counterparties to the Offset Swaps ("New Pay-Floating Swap"). The initial notional principal amount of each New Pay-Fixed Swap and New Pay-Floating Swap corresponded with the unamortized notional principal amount and amortization schedule of the relevant Original Swap or Offset Swap. Taxpayer identified the New Pay-Fixed Swaps and New Pay-Floating Swaps as hedging transactions on its books and records. On Date 5, Taxpayer terminated the remaining Offset Swap, the New Pay-Fixed Swaps, and the New Pay-Floating Swaps.

For Year 1, Taxpayer reported a capital loss of $j resulting from the termination of the Original Swaps. Taxpayer may have realized a loss of $k upon the termination of the Offset Swaps in Year 1, but it did not report this loss on its Year 1 return. Given the information we have received, we are unable to determine whether the Offset Swaps qualified as hedging transactions and were properly identified as hedging transactions. Thus, we are unable to conclude whether the loss realized from these transactions is capital or ordinary. Moreover, it is unclear why Taxpayer did not report this loss in Year 1.

Taxpayer did not make any cash payments to the counterparties to terminate the Original Swaps and the Offset Swaps, and it did not receive any cash payments from the counterparties to enter into the New Pay-Fixed Swaps and New Pay-Floating Swaps. The facts indicate that amounts that were due and owing between the parties upon the termination of the Original Swaps and the Offset Swaps, were applied to Taxpayer's costs of entering into the New Pay-Fixed Swaps and the New Pay-Floating Swaps. We note that the proper tax treatment, under sections 1.446-3, 1.446-4 and 1.1221-2, for payments made pursuant to these new swaps is beyond the scope of this technical advice memorandum.

LAW AND ANALYSIS:

For the years in issue, section 1.1221-2 provides rules governing the character of hedging gains and losses.[1] This regulation applies retroactively to all open taxable years. T.D. 8493, 1993-2 C.B. 258. Section 1.1221-2(a)(1) provides that generally the term capital asset does not include property that is part of a hedging transaction as defined in section 1.1221-2(b).

A hedging transaction is defined in section 1.1221-2(b) to include any transaction entered into by the taxpayer in the normal course of the taxpayer’s trade or business primarily to reduce risk of interest rate changes with respect to borrowings made or to be made by the taxpayer.

For these transactions, the general requirements for a proper identification were contained in section 1.1221-2(e). In the case of a hedging transaction that was entered into before January 1, 1994, and that remained in existence on March 31, 1994, an identification was considered timely if it was made by March 31, 1994. Section 1.1221-2(g)(1)(ii).

Section 1.1221-2(f)(1) provided rules concerning the effect of an identification or non-identification of a hedging transaction. For the years in issue, section 1.1221-2(f)(2) provided that a failure to make a proper identification under section 1.1221-2(e)(1) establishes that a transaction is not a hedging transaction. Thus, the rules of section 1.1221-2(a)(1) and (2) (providing special rules for the character of gain or loss) do not apply, and the character of gain or loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function or serves a similar function or purpose. In other words, an identification is relevant to determine the character of gains or losses resulting from a hedging transaction. Generally, an identification is required for a taxpayer to receive ordinary loss treatment for hedging losses. Where a failure to identify a hedging transaction is inadvertent and certain specified requirements have been satisfied, a taxpayer may, but is not required, to treat gain or loss from a hedging transaction as ordinary income or loss under section 1.1221-2(a)(1) and (2). Section 1.1221-2(f)(2)(ii).

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[1] Section 1221(a)(7) of the Internal Revenue Code was added pursuant to section 532 of the Ticket to Work and Work Incentives Improvement Act of 1999 (113 Stat. 1860). It is effective for transactions entered into on or after December 17, 1999, and thus does not apply to the years in issue.

An identification, however, is not determinative of whether a transaction satisfies the definition of a hedging transaction in section 1.1221-2(b) for other purposes, like the application of the hedge timing rules in section 1.446-4, discussed below. This is because the hedge timing regulations turn on the definition of a hedging transaction in section 1.1221-2(b), which does not invoke an identification requirement.

Section 446(b) grants to the Commissioner broad authority to determine whether a method of accounting clearly reflects income. For hedging transactions, a clear reflection of income is achieved by reasonably matching the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item being hedged. See section 1.446-4(b). The hedge timing rules in section 1.446-4, apply to hedging transactions as defined in section 1.1221-2(b) (whether or not the character of gain or loss from the transaction is determined under section 1.1221-2). Under a reasonable method of accounting for hedges of debt instruments, a taxpayer will take gains and losses from liability hedges into account by reference to the terms of the debt instrument and the period to which the hedge relates. See section 1.446-4(e)(4). Moreover, if a taxpayer hedges an item and disposes of, or terminates its interest in, the item but does not dispose of or terminate the hedging transaction, the taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item. To meet this requirement, the taxpayer may mark the hedge to market on the date it disposes of the hedged item. See section 1.446-4(e)(6).

Although the hedge timing rules in section 1.446-4 are not effective for the years in issue, they are instructive in determining whether a taxpayer has adopted a reasonable method of accounting that clearly reflects income. Section 1.446-4(a) provides that a hedging transaction as defined in section 1.1221-2(b) (whether or not the character of the gain or loss from the transaction is determined under section 1.1221-2) must be accounted for under the rules set forth in section 1.446-4. In Rev. Rul. 2003-127, 2003-52 I.R.B. 1245, the Service ruled that section 1.446-4(a) refers only to the definition of a hedging transaction in section 1.1221-2(b), and does not refer to the additional rules in section 1.1221-2(g)(2) regarding the treatment of unidentified transactions. In other words, the hedge timing rules in section 1.446-4 apply to any hedging transaction that satisfies the definition of a hedging transaction in section 1.1221-2(b), regardless of whether the transaction has been identified for purposes of characterizing gain or loss from the hedging transaction.

Assuming that Taxpayer entered into the Original Swaps primarily to reduce the risk of interest rate changes with respect to the floating-rate debt, the swaps are hedging transactions within the meaning of section 1.1221-2(b). However, because Taxpayer failed to identify the Original Swaps as hedging transactions pursuant to section 1.1221-2(e) and the transition rule in section 1.1221-2(g)(1)(ii), the losses resulting from the Original Swaps are properly treated as capital losses and the Service lacks authority under the hedging regulations to recharacterize the losses as ordinary.

Taxpayer recognized the losses on the Original Swaps in the same year that it retired the debt instrument. Accordingly, Taxpayer's treatment of the hedging losses clearly reflects income. As discussed above, this conclusion is unaffected by the fact that Taxpayer failed to identify the Original Swaps as hedging transactions for purposes of section 1.1221-2(e).

The request for technical assistance advice raised several other issues, including the application of section 1.446-3. Given that the Original Swaps and the Offsetting Swaps were entered into prior to the effective date of section 1.446-3, those regulations are not applicable. The remaining issues appear to be rendered moot given the analysis under the hedging regulations.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the Taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent .