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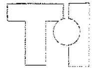

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New Temp. Regs. Favor Hedges

by Robert W. Wood • San Francisco

Most readers of *The M&A Tax Report* know that a tax development must be dramatic and important to be noted by the popular (*i.e.*, non-tax) press. *INDOPCO, Inc.*, 112 S.Ct. 1039 (1992), for example, or an important intangibles case, such as *Newark Morning Ledger Co.*, S.Ct. 4/20/93, may fall into this category, but most tax developments do not qualify. The treatment of business hedges can now be added to the list of hot-interest items (see, *e.g.*,"IRS, In Big Victory For Business, Shifts Its Position On Losses Linked To Hedging," *Wall St. J.*, 10/19/93, p. A2). The IRS release of temporary and proposed regulations dealing with the character of gain or loss from hedging transactions is important and has been so recognized by the business community.

According to the preamble to the rules, the questions at issue arose in the wake of *Arkansas Best Corp.*, 485 US 212 (1988). Since *Arkansas Best*–indeed, even before that decision put its various glosses on the *Corn Products* doctrine–the Service somehow found that virtually any hedge gave rise to capital, rather than ordinary, loss. (Gains were generally also capital, but it was awfully tempting for the Service to seek ordinary income treatment where the gains were big.)

Now, under new Temp. Reg. 1.1221-2T(a)(1), property that is part of a hedging transaction is *not* a capital asset. Short sales and options are treated similarly. Thus, when a short sale or option is part of a hedging transaction, any gain or loss on the short sale or option is treated as ordinary. While the character of gain or loss on a short sale or option will generally be determined under Sections 1233 and 1234 (instead of under Section 1221), the treatment of short sales and options in the Section 1221 temporary regulations is meant to harmonize and unify the characterization question.

The temporary regulations now provide a single set of rules for determining the character of gain or loss from hedging transactions. To complete this circle, temporary regulations under Sections 1233 and 1234 cross-reference Section 1221,

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stating that Temp. Reg. 1.1221-2T governs the character of gain or loss on short sales and options that are part of hedging transactions.

What is a Hedge?

The new temporary and proposed rules define a hedging transaction as a transaction that a taxpayer enters into in the normal course of business primarily to reduce the risk of interest rate or price changes, or currency fluctuations. This narrower definition of the traditional hedge concept would therefore not provide ordinary treatment for gains or losses on the disposition of stock if it was acquired to protect the goodwill or business reputation of the party purchasing it. Likewise, gain or loss recognized on the disposition of stock that had been purchased to secure a supply of goods in the future would not be treated as ordinary, as it would not be viewed as a true hedging transaction under the new rules.

The new rules also provide other exclusions. For example, they do not apply when a taxpayer hedges a dividend stream, the overall profitability of a business unit, or other business risks that do not relate directly to interest rate or price changes, or to currency fluctuations. Indeed, the risk being reduced must relate to ordinary property or obligations, or to the taxpayer's borrowings. This reference to "ordinary property" invites a definition that the temporary regulations provide: ordinary property is property which, if sold or exchanged, could never produce capital gain or loss. An ordinary obligation likewise could never produce capital gain or loss.

Following this distinction, the new rules indicate that a loss on a hedge will not be treated as ordinary when a gain on the item being hedged could be treated as capital gain. Consequently, when Section 1231 assets are hedged, they will not qualify for ordinary treatment. Likewise, hedges of noninventory supplies are excluded from the definition because they are capital assets. Noninventory supplies, such as jet fuel used by an airline, would still constitute capital assets, even though consuming the supply would give rise to an ordinary deduction. Therefore, hedges against such assets would still produce capital gain or loss. Just how broad this category is is not clear, although presumably, any energy or fuel item would be treated in the same way, as would feed for animals.

Multiple Properties

What if a transaction hedges several distinct risks? The temporary regulations address this situation too, providing that such a transaction will qualify for ordinary treatment only if all of the risks being hedged (or all but a *de minimis* amount of risk) are related to ordinary property and ordinary liabilities.

Interestingly though, it must be the taxpayer's risk that the hedge seeks to minimize, rather than someone else's. Thus, the rules do not apply when a taxpayer hedges the risk of a related party. In the preamble, the Service invites comments as to the scope and definition of the treatment of transactions between related parties.

Effective Dates; Identification

One quite dramatic effect of the rules is their timing: they are effective for *all* open tax years. Nonetheless, identification and recordkeeping requirements for hedging transactions must be met for all such transactions entered into after 1993. For transactions entered into before 1994, and that remain in existence on 3/31/94, same-day identification rules apply, except that the identification may be made until that date.

The basic thrust of the identification requirement is that an unambiguous labeling of the hedging transaction must be made. This identification must be made on, and retained as a part of, the taxpayer's books and records. It must specify both the hedging position and the item(s) or aggregate risk that is being hedged.

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Notwithstanding this apparently clear guidance, the IRS demonstrates some ambivalence regarding what kind of identification will suffice. It seems likely that certain types of hedging transactions will be the subject of special identification rules. It is also conceivable that somewhat relaxed identification rules may be issued for a series of hedges, as opposed to requiring a transaction-by-transaction record. For the time being, however, the Service indicates that any reasonable method of identifying the items or aggregate risk being hedged will likely suffice.

Of course, once a taxpayer has identified a transaction as a hedging transaction, the implicit election will be binding on the taxpayer. Conversely, if a taxpayer fails to make the identification, that by itself will establish that the transaction is *not* a hedging transaction. This obviously gives identification of the transaction very high stakes.

Role Reversal

The temporary and proposed regulations were hailed as a major about-face, as they reverse the IRS litigating position that most hedging gains and losses are capital. Given the limitations on the deductibility of capital losses, this made the loss produced on a hedging transaction of limited utility, and made hedging transactions materially more expensive (at least from a tax viewpoint).

The reversal of position signalled by the proposed and temporary regulations comes on the heels of the IRS defeat in *Federal National Mortgage Association*, 100 TC No. 36 (1993). There, the Tax Court concluded that *Arkansas Best* did not stand in the way of treating gains and losses on business hedging transactions as ordinary rather than as capital. (See "Hedging Your Bets? Tax Court Blesses Fannie Mae," 2 *M&A Tax Rep't* 1 (August 1993), p. 1.)

While the IRS surely could have acquiesced in the *Fannie Mae* case, the temporary rules are to be lauded as a major help to taxpayers (and to the Government) in clarifying this particularly nettlesome area. The identification requirement now added should eliminate most of the disputes that arise, obviating the 20-20 hindsight that has often characterized the hedge field.

Perhaps the most significant area in which there is room for improvement relates to combination hedges. One example, posed by David Garlock (who was counsel for the taxpayer in the *Fannie Mae* case), involves a manufacturer buying a call option on cotton as a hedge against future price increases. If the manufacturer later decides to reduce the cost of the call option by selling a put option on cotton, that later transaction is probably not risk reducing by itself. Nonetheless, the entire transaction taken together is risk reducing and should arguably be so treated. (See "Hedging Regs. Receive Rave Reviews," 60 *Tax Notes* 17, 10/25/93, p. 391.) ■