HEDGING TRANSACTIONS: TAX TREATMENTS

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WHAT IS A HEDGE?

- "Hedging transaction" means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily to manage the risk of (i) price changes or currency fluctuations with respect to ordinary property, (ii) interest rate or price changes or currency fluctuations with respect to borrowings or ordinary obligation, or (iii) such other risk as the Secretary may prescribe. Section 1221(b)(2), Treas. Reg. 1.1221-2(b)

QUALIFYING AS A HEDGING TRANSACTION FOR TAX PURPOSES:

- Must be entered into to manage risk.
  - Before 1999, the standard was “risk reduction”. The current standard “risk management” is broader.
  - “Facts and circumstances” test.
- The transaction must be entered into “primarily” to manage risk.
  - A test of “purpose and intent”.
  - Not a requirement to be the “sole purpose”.
    - “Primarily” has been interpreted to mean of principal importance and of greater important than any other reason.
  - “Aggregate risk” is ok.
- The item being hedged must constitute ordinary property, ordinary obligations, or borrowings.

QUALIFYING AS A HEDGING TRANSACTION FOR TAX PURPOSES (CONT'D):

- Written Call and Put Options: can be hedging transactions.
- Fixed-to-Floating Price Hedges: a transaction that economically converts a price from a fixed price to a floating price may reduce risk and constitute a hedging transaction.
- "Hedge of a Hedge": A transaction entered into primarily to offset all or any part of the risk management effected by one or more hedging transactions is a hedging transaction.
- Partial Hedges can qualify. It is not required that a hedge completely eliminates the risk identified. A taxpayer can hedge all or any portion of its risk for all or any part of the period during which it is exposed.
- Not a Hedge: a weather derivative used by an energy producer to hedge against the decrease in volume of sales from variations in weather patterns would not qualify as a hedging transaction because it does not mitigate the risk of interest rate or price changes, or currency fluctuations.

QUALIFYING AS A HEDGING TRANSACTION FOR TAX PURPOSES (CONT'D):

- Consolidated group
  - Single entity approach: the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation.
    - Intercompany transactions are not hedging transactions.
  - May elect separate-entity treatment of its hedging transactions.
    - An intercompany transaction can be a hedging transaction.

IMPORTANCE OF QUALIFYING AS A HEDGE

- Consequence of not qualifying as a hedge: character and timing mismatches between a hedge and the underlying hedged transaction can arise.
  - Character mismatch (capital vs. ordinary)
    - Limited use of capital losses: corporations can only deduct capital losses against capital gains
  - Timing mismatch
    - Avoiding Section 1092 straddle rules: losses on a straddle position may be deferred to the extent that unrecognized gain is present in an offsetting straddle position.
    - Section 1092 does not apply if the item in question is entered into as part of a hedging transaction.

TAX TREATMENT OF A HEDGING TRANSACTION

- Gains and losses from a hedging transaction are treated as ordinary in character to produce a character match between the hedge and the hedged item.
  - Section 1221 and Treas. Reg. 1221-2 provide that the term “capital asset” does not include property that is part of a “hedging transaction”.
- The method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. Treas. Reg. 1.446-4
  - The method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain or loss from the item or items being hedged.
  - Does not affect the hedged item.

COMPLIANCE: IMPORTANCE OF DOCUMENTATION AND IDENTIFICATION

- Taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions were entered into primarily to manage the taxpayer's risk.
  - Document a hedging program properly.
  - Management should prescribe guidelines in the document.
  - Hedging transactions should be executed within the guidelines.

COMPLIANCE: IMPORTANCE OF DOCUMENTATION AND IDENTIFICATION (CONT'D)

- Identification Requirements: both the hedge and the hedged item must be identified
  - Timing: must identify a hedging transaction before the close of the day of entering into the transaction; and must identify the hedged item substantially contemporaneously with entering into the hedging transaction (within 35 days after entering into the hedging transaction);
  - Content: identifying the transaction that creates risk and the type of risk created;
  - May make each identification, or establish a system pursuant to which the identification is indicated by the type of transaction or by the method by which the transaction is consummated or recorded.
- Record keeping:
  - Identification must be made on, and retained as part of, the taxpayer's books and records
  - Specified for tax purposes (identification for financial accounting and regulatory purposes not sufficient).
  - The accounting methods used for each type of hedging transactions need to be recorded on the books and records and to show how "clear reflection of income" is satisfied.

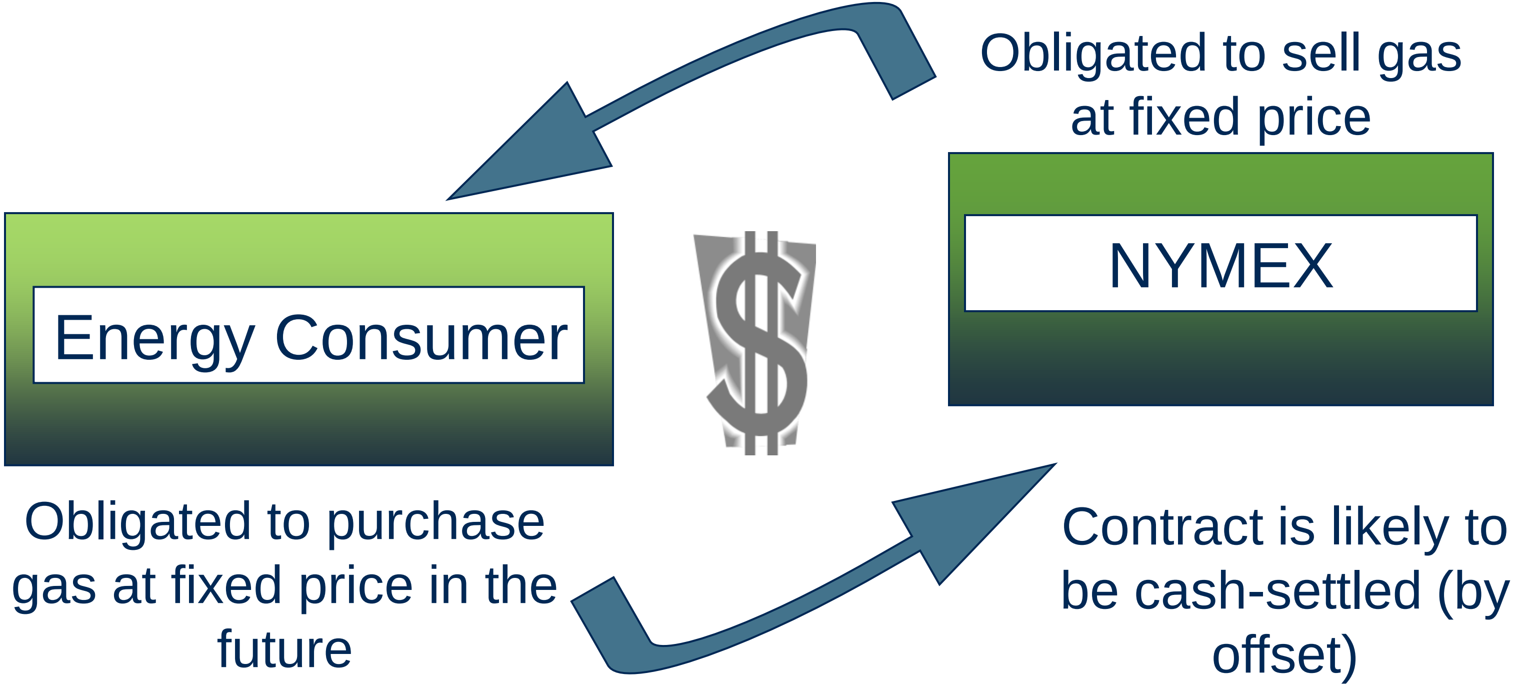
EXAMPLES OF COMMODITIES RELATED FINANCIAL PRODUCTS

- Futures contract
- Forward contract
- Option
- Notional principal contract (“NPC“)

WHAT IS A FUTURES CONTRACT?

- A futures contract is an agreement contemplating the future sale/purchase of specified property (or an index)
- With respect to commodities futures contracts, the contract is to purchase/sell a specific quantity and grade of a commodity for delivery at a specified time and place in the future

FUTURES CONTRACT



WHAT IS A REGULATED FUTURES CONTRACT (A "RFC")?

- With respect to commodities, most common form of futures contracts are RFCs
- A RFC is defined in Code Section 1256 as a futures contract that is:
  - traded on or subject to rules of a qualified board or exchange (generally, all U.S. and limited foreign exchanges),
  - subject to a daily system of mark-to-market and
  - not required to be reported as a “swap” under the Commodity Exchange Act (i.e., interest rate, commodity, currency and similar swaps treated as notional principal contracts for tax purposes)
- Example: futures contracts not classified as swaps that are traded on the NYMEX, ICE, and the CME
- If the contract is not a RFC then it is taxed as a futures contract or NPC (to be discussed)

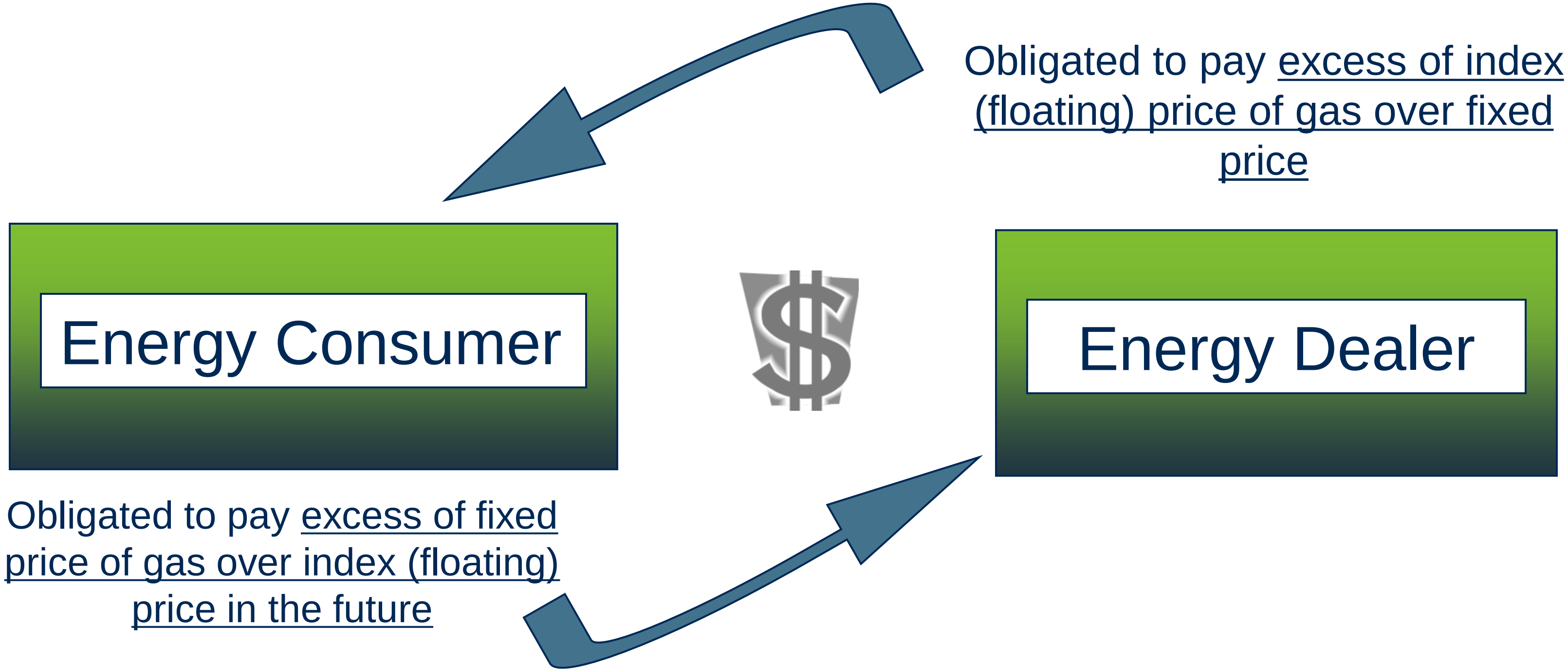
TAXATION OF RFCS

- RFCs are taxed as Section 1256 contracts:
  - 60/40: 60% long-term capital gain or loss and 40% short-term capital gain or loss
  - mark-to-market
- If identified as a hedge, the tax treatment of a hedging transaction applies to the RFC.

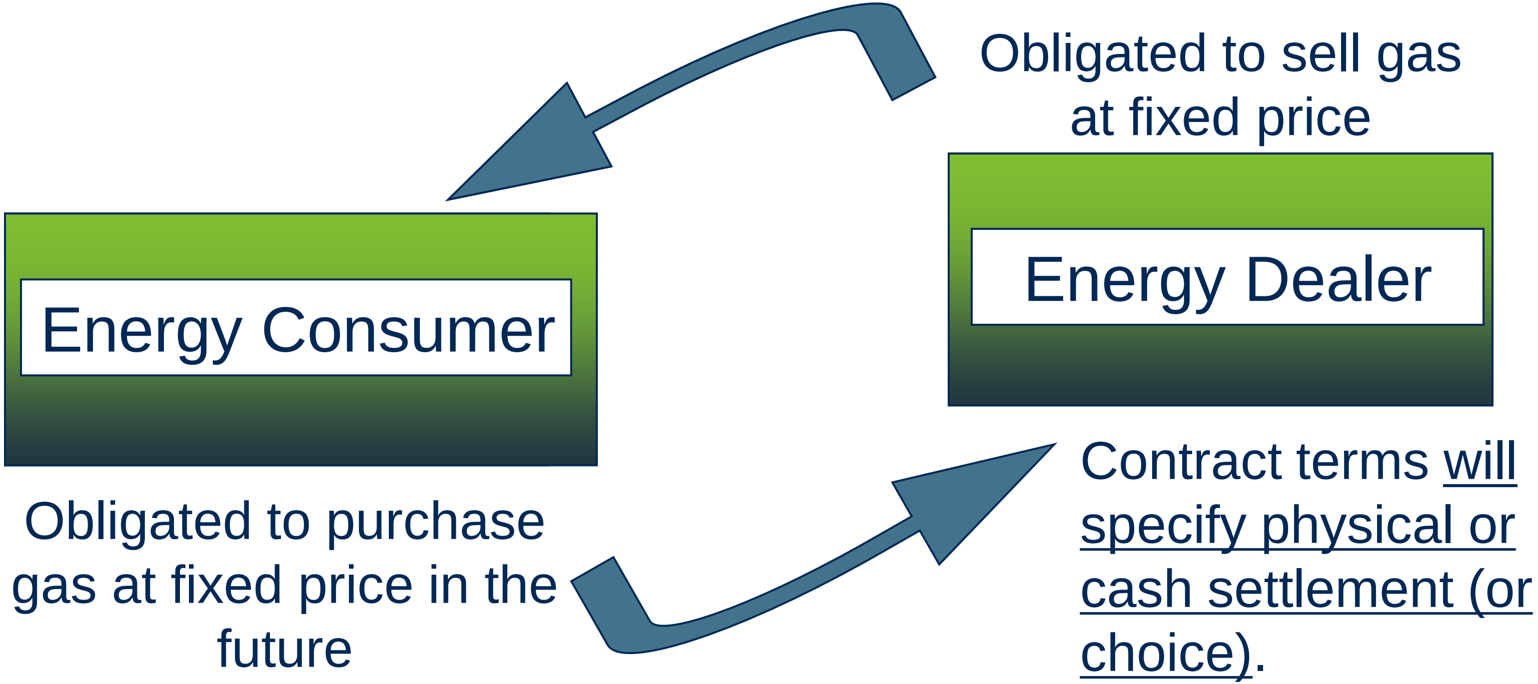
WHAT IS A "FORWARD" CONTRACT?

- A forward contract is a privately negotiated, bilateral agreement between two parties contemplating the future sale/purchase of specified property (or an index):
  - physical or cash settlement
- Forward contracts are not exchange traded, and terms are not standardized
  - illiquid
  - counterparty credit exposure
- All future contracts that are not RFCs are treated as forward contracts for tax purposes.

FORWARD CONTRACT WITH A CASH SETTLEMENT



FORWARD CONTRACT WITH A PHYSICAL SETTLEMENT



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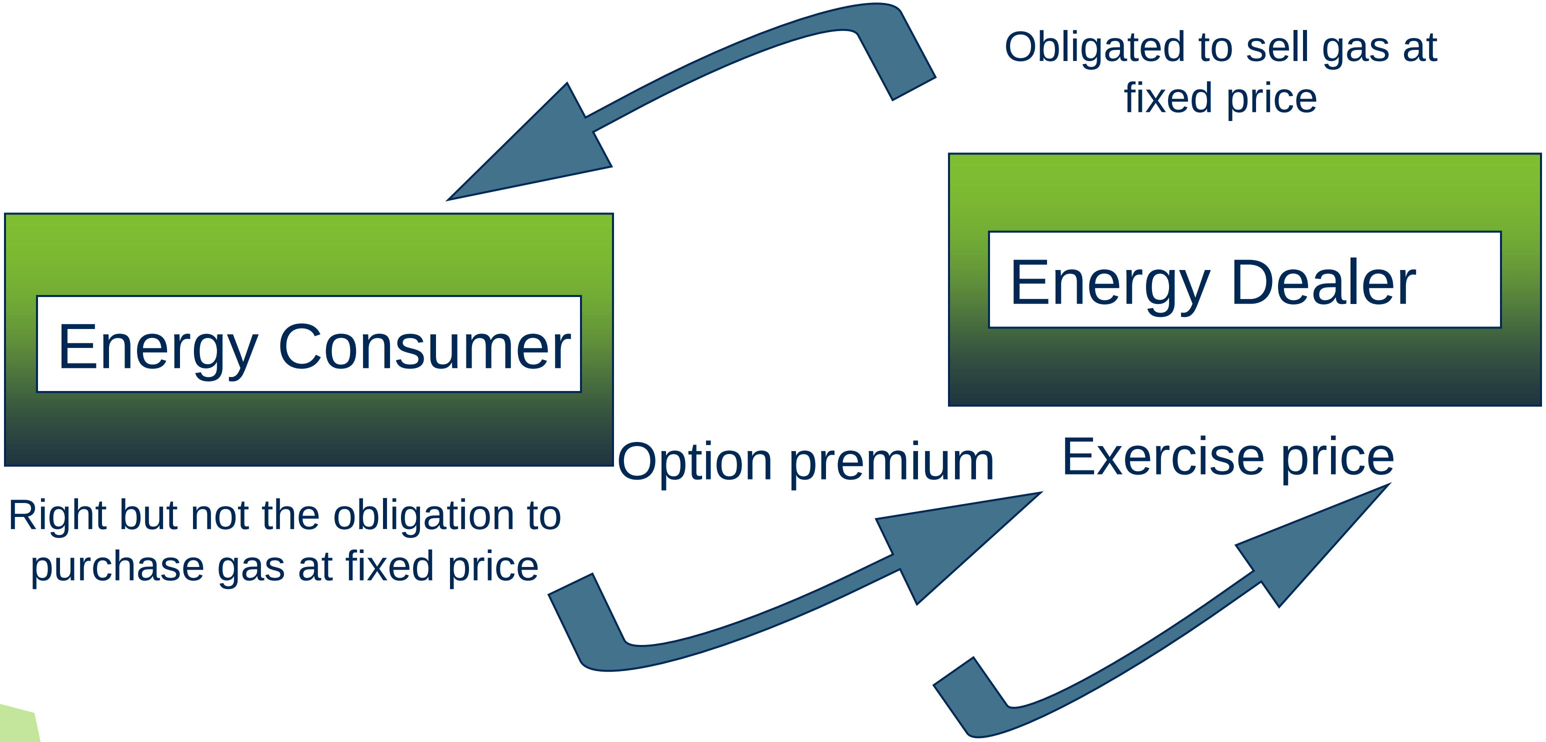
TAXATION OF A FORWARD CONTRACT

- Section 1256 does not apply to forward contracts.
- The following tax treatment generally applies:
  - physical settlement: equivalent to the sale of underlying property
    - the deliverer recognize gain or loss equal to the difference between the exercise price and its basis in the underlying property
    - recipient takes a basis in the underlying property equal to the exercise price
  - cash settlement: IRS generally views the cash settlement as economically identical to physical settlement
    - Cash settlement amount is equal to the difference between the FMV of the deliverable property over the exercise price.
    - Character of gain or loss is based on the character of the underlying property.
  - termination: under the 2004 proposed regulations, payments to terminate a forward contract give rise to capital gain or loss if the contract is a capital asset in the hands of the taxpayer.
- If identified as a hedge, the tax treatment of a hedging transaction applies.

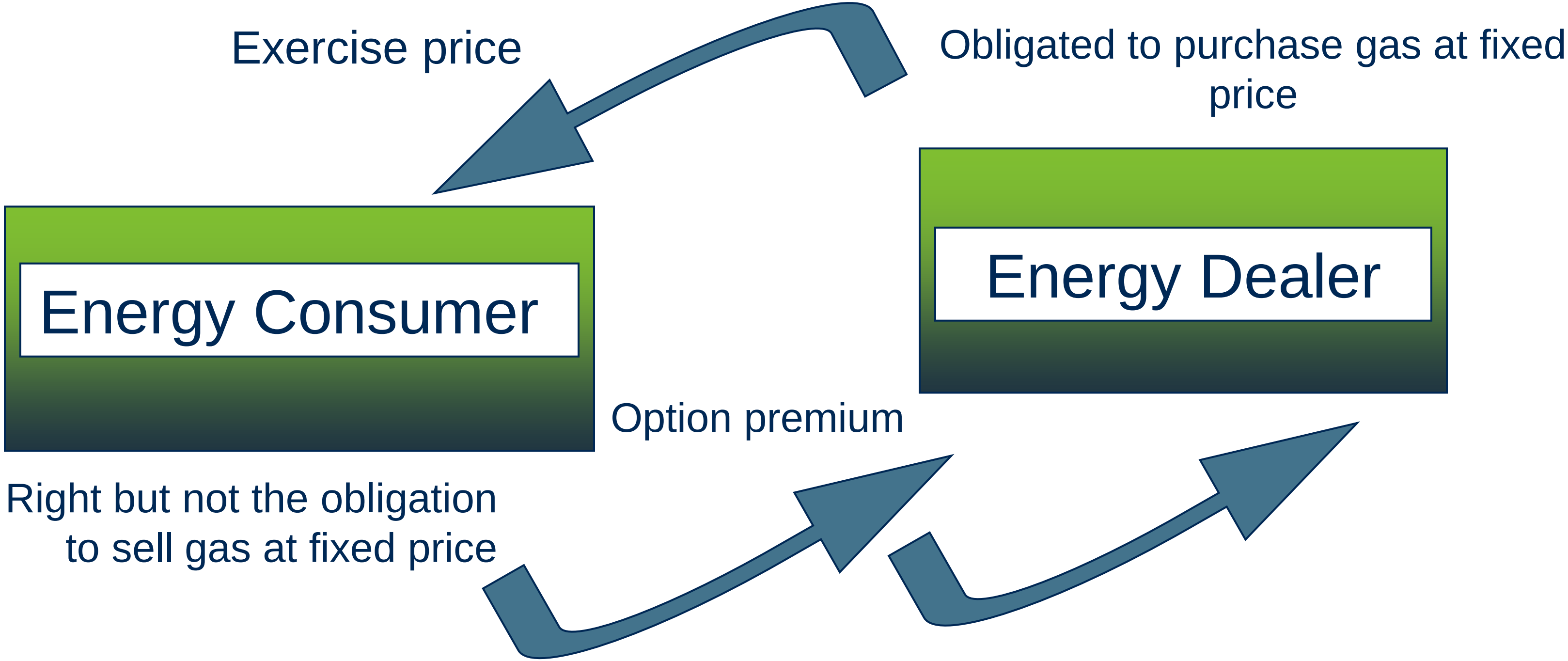
WHAT IS AN "OPTION" CONTRACT?

- An agreement providing one party (the option buyer) with the right – but not the obligation – to buy or sell specified property (or an index) at a fixed price in the future. The option seller becomes obligated to buy or sell property upon an exercise by the option buyer
  - examples include: put options and call options.
- Options may be:
  - exchange-traded (U.S. or foreign) or privately negotiated (over-the-counter)
  - cash settled or physically settled

CALL OPTION CONTRACT PHYSICAL SETTLEMENT



PUT OPTION CONTRACT PHYSICAL SETTLEMENT



HOW ARE OPTIONS TAXED?

- Options that are not Section 1256 contracts generally are subject to Section 1234
- General Rule: no gain or loss until option lapses, is exercised, or is sold/cash settled
  - sale/lapse/expiration – gain or loss is recognized equal to premium paid or received (or the difference between sale price and premium paid in the case of a sale); character is based on underlying property
  - exercise (physical settlement) – treated as a sale or purchase of property; adjust sales price or basis for premiums
  - cash settlement – gain (loss) recognized equal to amount received (paid) in the settlement (adjusted to reflect premiums); character is based on underlying property
- If identified as a hedge, the tax treatment of a hedging transaction applies.

WHEN ARE OPTIONS TAXED AS SECTION 1256 CONTRACTS?

- Certain options traded on or subject to rules of a qualified board or exchange:
  - non-equity options (any listed option not an equity option)
  - dealer equity options (any listed equity option purchased or granted by an options dealer in the normal course of business)
- Commodities options that are listed in a qualified board or exchange but are not classified as swaps are treated and taxed as Section 1256 contracts, except when part of an identified hedge.

NOTIONAL PRINCIPAL CONTRACTS: SWAPS, CAPS AND FLOORS

- A Notional Principal Contract (an "NPC") is a financial instrument that provides for the payment of amounts by one party to another party at specified intervals over the life of the contract. The payment must be calculated by reference to a "specified index" and a "notional principal amount," and be given in exchange for specified consideration or a promise to pay similar amounts. (Treas. Reg. § 1.446-3(c)(1)(i)).
  - The proposed regulation in 2011 would broaden the definition to include credit default swaps and certain weather derivatives.
- NPCs are over-the-counter contracts and involve counterparty credit risks.

EXAMPLES OF SWAPS

- Commodity swap.
  - A swap in which the notional principal amount is expressed in units of a commodity and the specified index is a commodity price or commodity price index. Typically one party agrees to make periodic payments equal to a specified fixed price times the notional principal amount, and the counterparty agrees to make periodic payments equal to a specified index times the notional principal amount. (Prop. Treas. Reg. 1.446-3(d)(3))
- Interest rate swap.

FLOATING TO FIXED GAS PRICE SWAP

Periodic payment: excess of index (floating) price of gas over fixed price

(Makes payments based on a fixed contract amount)

Energy Consumer

Energy Dealer

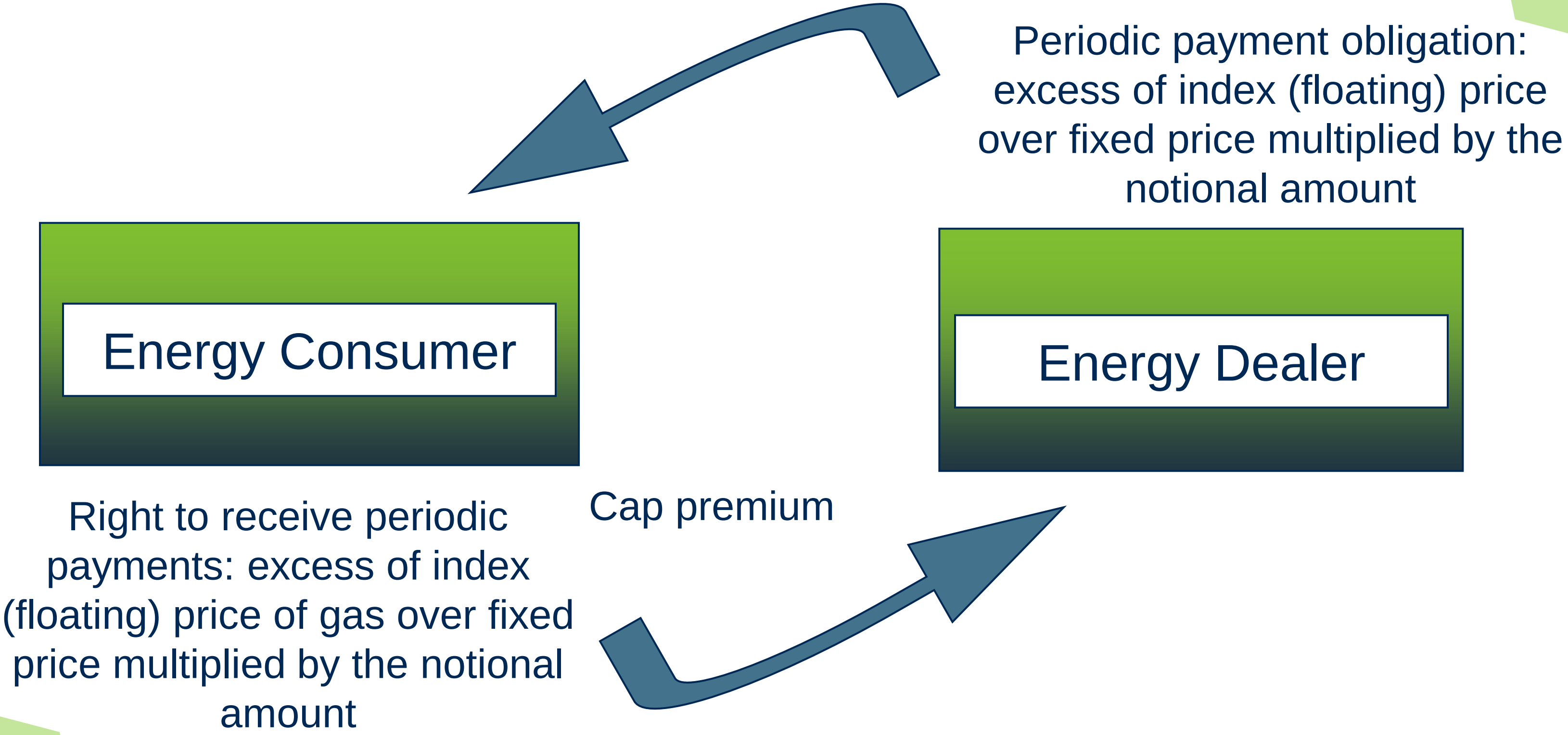
Periodic payment: excess of fixed price of gas over index (floating) price

(Assumes floating component of the swap)

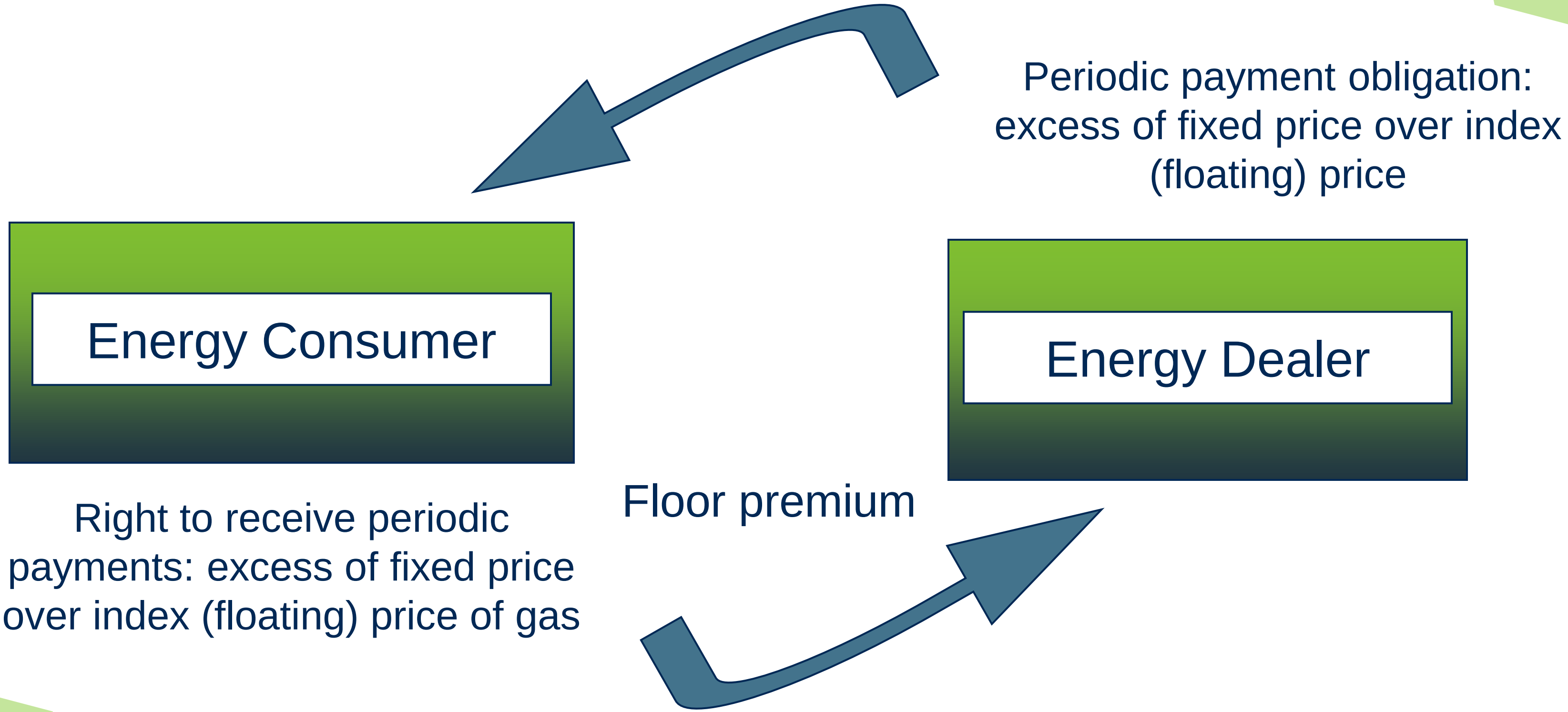
FLOATING-FOR-FIXED GAS PRICE SWAP

- Assume that on February 22, 2013 the Henry Hub Spot Price for natural gas is $3.24 per MMBtu
- Assume the swap is based on a notional amount of 100 million MMBtu
- Further assume the energy consumer agrees to pay the dealer a fixed amount of $3.00 per MMBtu
  - Henry Hub is a specified index and the swap qualifies as a NPC under 1.446-3
  - All payments under the swap are periodic
  - Swap payments for one period: $300,000,000 (3x100MM) (fixed leg), $324,000,000 (3.24X100MM)(floating leg)
    - Net Payment $24,000,000
    - Note: the fixed and floating payments would be netted, so that the consumer would receive a net swap payment of $24,000,000

CAP AGREEMENT



FLOOR AGREEMENT



HOW ARE NPCS TAXED?

- Three categories of payments
  - periodic payments: accrual and ordinary character
    - under Treasury Reg. 1.446-3(e)(2)(i), a taxpayer recognizes the ratable daily portion of periodic payments in the tax year to which it relates (similar to OID accruals)
  - nonperiodic payments (such as premiums charges for a cap or floor agreement): accrual and ordinary character
    - all taxpayers regardless of their method of accounting must recognize the ratable daily portion of a non-periodic payment for the taxable year to which it relates
  - termination payments:
    - recognized when the contract is extinguished, assigned, or exchanged
    - under the 2004 proposed regulations, the termination payments give rise to capital gain or loss if the NPC is a capital asset in the hands of the taxpayer
- If identified as hedge, then the tax treatment of a hedging transaction applies.

NPC TIMING ISSUES: CONTINGENT NON PERIODIC PAYMENTS

- Example: A common commodity swap arrangement provides for a payment, at the conclusion of the agreement's term, in which one party will pay to or receive from the other an amount equal to the appreciation or depreciation in the value of a notional amount of the commodity during the term of the agreement.
- Not a "termination payment" under the 2004 proposed regulations.
- In Notice 2001-44, the IRS proposed noncontingent swap method that requires taxpayers to project the expected amount of contingent payments, to take into account annually the appropriate portions of the projected contingent amounts, to reflect the projected contingent amounts annually, and to reflect the differences between projected amounts and reflect projected amounts through adjustments.
- Prop. Treas. Reg. §1.446-3(g)(6) (2004) provides for similar treatment and in addition provides an elective mark-to-market methodology for certain contracts.

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CAMP DISCUSSION DRAFT CHANGES

- On January 24, 2013 Rep. Camp, the Chairman of the House Ways and Means Committee, released a discussion draft of the taxation of financial products (the "Proposal")
- The Proposal generally provides that all futures, forwards, options and NPCs would be required to be marked-to-market at the end of a tax year and the change in value of such instrument would be treated as ordinary income or loss
  - Businesses that enter into qualifying hedges (including hedges with derivatives) would be exempt from such mark-to-market treatment
- Code Section 1256 would be repealed under the Proposal
- Trading related to physical commodities generally would be exempted, but if the trade were subject to a tax straddle with a derivative, such transaction would be marked-to-market under the Proposal
- The Proposal would allow for simplified hedging identification
  - If the hedge was identified for financial accounting purposes, it would be treated as properly identified (as opposed to identification on the day the hedge is executed)
- The Ways and Means Committee is currently contemplating the Proposal

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CIRCULAR 230

TO ENSURE COMPLIANCE WITH TREASURY DEPARTMENT CIRCULAR 230, YOU ARE HEREBY NOTIFIED THAT ANY DISCUSSION OF U.S. FEDERAL INCOME TAX ISSUES HEREIN IS NOT INTENDED OR WRITTEN TO BE RELIED UPON, AND CANNOT BE RELIED UPON, BY ANY PERSON FOR THE PURPOSE OF AVOIDING PENALTIES THAT MAY BE IMPOSED REGARDING THE TRANSACTIONS OR MATTERS ADDRESSED HEREIN.

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