

Current Federal Tax Developments

By William R. Pomierski

Separate vs. Integrated Contracts, Foreign Currency Contracts Under Code Sec. 1256, Prepaid Forwards and Contingent Exchange Traded Notes

There were a number of important calendar year 2007 developments relating to financial product taxation. Although some of these developments at first glance appear to have limited application to specific products or transactions, a closer look reveals potentially broader implications.

First, in Chief Counsel Memorandum AM 2007-0014,¹ the IRS considered whether long and short option transactions entered into by a taxpayer with the same counterparty, relating to the same underlying property, and with a number of common terms, should be treated for federal income tax purposes as a single derivative contract, or as separate instruments. Although the key issues addressed by this Chief Counsel Memorandum relate to the integrated hedge rules of Reg. §1.1275-6, the IRS's single-versus-separate instrument analysis is relevant to many common financial product transactions involving two or more instruments.

Second, in Notice 2007-71, the IRS reversed itself and confirmed that over-the-counter (OTC) currency options are not "foreign currency contracts" for purposes of Code Sec. 1256. The certainty provided by this Notice should generally be viewed as a positive development not only for options, but also for other forms of OTC currency derivatives not involving bank forward contracts, such as currency swaps. Beyond the Code Sec. 1256 contract classification issue, Notice 2007-71 is also important in that it highlights the significance of considering legislative history and Congressional intent in financial product tax analysis, which is often overlooked.

Third, in Rev. Rul. 2008-1, the IRS ruled that prepaid currency forward contracts and similar transactions (such as exchange traded notes) should be considered indebtedness for federal income tax purposes. Rev. Rul. 2008-1 was issued in conjunction with Notice 2008-2, which signals that the IRS may be engaging



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William R. Pomierski is a Partner in the international law firm of McDermott Will & Emery LLP, resident in the Chicago office. He is a former Editor-in-Chief of the JOURNAL OF TAXATION OF FINANCIAL PRODUCTS.

in a broader review of tax accrual principles in connection with financial product transactions. Rev. Rul. 2008-1 may also have broader implications for determining whether debt instruments with contingent principal are properly characterized as indebtedness, or as derivatives, for federal income tax purposes.

Separate Contract Analysis— Chief Counsel Advice Memo AM 2007-0014

As a general matter, offsetting financial product transactions entered into as part of a larger risk management strategy are required to be accounted for (in terms of character and timing) independently of each other. Reg. §1.1275-6, however, allows taxpayers to elect tax integration of a qualifying debt instrument (QDI) and a hedge or combination of hedges that meet certain requirements.²

A qualifying hedge is defined for purposes of Reg. §1.1275-6 to include any financial instrument—such as spot, forward, or futures contracts, options, swaps, debt instruments or combinations thereof—that when combined with a QDI will permit the calculation of a yield to maturity or would qualify as a variable rate debt instrument under Reg. §1.1275-5. Reg. §1.1275-6 requires a high degree of correlation between the terms of the hedging transaction and the terms of the QDI being hedged thereby.³ To qualify for integrated treatment, the resulting synthetic debt instrument must have the same term to maturity as the remaining term of the QDI.⁴

Basically, Reg. §1.1275-6 provides that if a taxpayer elects to integrate a QDI and a qualifying hedge,⁵ the separate existence of the hedge is ignored and the taxpayer accounts for the QDI on a “synthetic” basis. The synthetic debt instrument is treated for all federal income tax purposes as the combination of the QDI and the hedging transaction, and is subjected to the general rules for debt instruments under Code Sec. 163(e) and Code Secs. 1271 through 1275, with terms (such as issue date, issue price, etc.) determined under Reg. §1.1275-6(f)(2) through (13).⁶

Chief Counsel Memorandum AM 2007-0014 (the “Chief Counsel Memorandum”), addressed a transaction in which a corporation issued notes convertible into its stock, and then hedged the notes by (1) purchasing call options on its common stock (the “purchased options”) with a strike price identical to the conversion price under the convertible notes and (2) simultaneously selling (writing) call options on its common stock (the “written options”) at a higher strike price. The purchased and written options were entered into on an OTC basis between the taxpayer and the same bank counterparty. The net effect of the options in relation to the taxpayer’s convertible notes was to synthetically increase the conversion price to the strike price of the written options. The corporation then elected integration under Reg. §1.1275-6 with respect to the convertible notes and the purchased options, but did *not* elect to integrate the written options. Integration by the issuer under Reg. §1.1275-6

In addition, the Chief Counsel Memorandum provides support for the conclusion that a transaction written as a single financial product should not be bifurcated, but should instead be treated as a single instrument.

had no effect on holders of the convertible notes, or on the counterparty to the options.⁷

As described above, the terms of a *synthetic* debt instrument, such as the issue price, are determined under Reg. §1.1275-6(f)(2) through (13). By integrating the convertible notes and the purchased options, the resulting synthetic convertible notes were issued with original issue discount (OID) since the premium paid by the taxpayer for the purchased options reduced the issue price of the synthetic convertible notes.⁸ For example, assume the convertible notes were issued to investors for \$1,000 and require the taxpayer to pay \$1,000 at maturity. Assume also that the premium paid by the taxpayer for the purchased options is \$100, and that the premium received by the taxpayer upon the sale of the written options is \$90. By integrating the purchased options with the convertible notes, under Reg. §1.1275-6(f)(4) the synthetic convertible notes have an issue price of \$900, resulting in OID of \$100. Under the principles of Code Sec. 1272, the issuer would accrue an interest expense deduction with respect to the synthetic convertible notes each tax year equal to the sum of the coupon interest that accrues during the year plus an amount of OID for such year (based on a

constant yield to maturity for a debt instrument with an issue price of \$900 and a face amount of \$1,000 due at maturity).⁹ Absent integration, the purchased options would have been governed by Code Sec. 1032(a), which provides that no gain or loss shall be recognized by a corporation “with respect to the lapse or acquisition of any option ... to buy or sell its own stock (including treasury stock).” Code Sec. 1032 should likewise apply to the taxpayer’s written options.

According to the Chief Counsel Memorandum, the taxpayer entered into the transaction in order to raise capital for general corporate purposes. The taxpayer (“X”) engaged in the option transactions instead of issuing the convertible notes at a higher conversion price “because X believes that there is a deeper market for convertible notes with the actual conversion price, but X desires to avoid the potential dilution from the conversion of its notes (for example, the reduction in earnings per share of X’s common stock) at prices lower than that higher conversion price. X also believes that the accounting treatment of this transaction is superior to the accounting treatment that would apply if X issued nonconvertible, discount notes instead of the actual notes and the hedges.”

By electing to integrate the purchased options with the convertible notes, the premium paid for the purchased options resulted in OID that was deductible by the taxpayer over the life of the synthetic notes. If the taxpayer had also elected to integrate the written options, the premium received on the sale of such options would have been taken into account as an addition (increase) in the issue price of the synthetic notes, thereby reducing the amount of OID. One of the questions under consideration by the IRS in the Chief Counsel Memorandum was whether the taxpayer should have been required to integrate the convertible notes with both the purchased options and the written options, or neither of them.¹⁰ The answer to this question turned, in part, on whether the purchased options and the written options should be treated as a single instrument or as separate transactions for federal income tax purposes.

Although the amount of the prepayment generally reflects the actual forward price of the underlying property discounted to reflect the time value of money, as a general matter neither party to a prepaid forward recognizes any income or deduction until the forward contract matures.

Based on Rev. Rul. 88-31, Rev. Rul. 2003-97 and related authorities,¹¹ the IRS concluded that the purchased options and the written options were properly treated by the taxpayer as separate transactions for tax purposes. In reaching this conclusion, the IRS noted the existence of the following facts which supported the separate nature of the options:

“X may sell the hedges [purchased options] and retain its position in the warrants [written options] and Bank [the counterparty] may sell the warrants and retain its position in the hedges; the warrants expire several months later than the hedges; the hedges may be exercised only through automatic exercise upon conversion of the corresponding notes but the

warrants are European style and do not refer to the notes or the hedges; and X and Bank have no rights of offset with respect to the other party’s obligations in any bankruptcy or liquidation proceeding.”¹² Other relevant facts supporting the separate treatment of the options included the following: The purchased options could be settled physically or on a net share or net cash basis, whereas the written options could be settled only on a net share or net cash basis; the options were separately documented; and the option premiums were separately stated.

As part of its analysis, the IRS considered whether the options should be treated as a single instrument for federal income tax purposes merely because the taxpayer entered into the options as part of the same transaction. The IRS properly concluded, however, that this fact alone did not justify treating the options as a single instrument.

The IRS’s single-versus-separate instrument analysis in the Chief Counsel Memorandum should be useful in considering the tax implications of financial product transactions in general. Specifically, the Chief Counsel Memorandum supports the notion that separate and independent transactions entered into between the same parties will be given independent tax significance as long as the particular transactions are separable based on the criteria established in Rev. Rul. 88-31, Rev. Rul. 2003-97 and related authorities. In addition, the Chief Counsel Memorandum

provides support for the conclusion that a transaction written as a single financial product should not be bifurcated, but should instead be treated as a single instrument. For example, many equity collar transactions entered into by high net worth investors for the purpose of hedging price risk with respect to equity securities involve transactions consisting of a purchased put option and a written (sold) call option. In many cases, the collar is written as a single instrument incorporating the terms and conditions of both options. Practitioners have generally concluded that an equity collar written as a single integrated option transaction should be taxed as a single derivative transaction, rather than as separate put and call options. This characterization is relevant for determining whether or not premiums need to be taken into account with respect to the separate put and call options. The Chief Counsel Memorandum provides further support for this view that an integrated equity collar is to be characterized as a single derivative instrument for federal income tax purposes.

Over-the-Counter Currency Contract Classification Under Code Sec. 1256

As described in my last column,¹³ four of the five categories of “section 1256 contracts” apply only to contracts *traded on or subject to the rules of* a qualified board or exchange. “Foreign currency contracts” are the only category of Code Sec. 1256 contract that need not be traded on or subject to the rules of a qualified board or exchange.

A “foreign currency contract” is defined in Code Sec. 1256(g)(2) as a contract that meets three requirements: (1) the contract must contemplate delivery or settlement by reference to a currency that is traded on a qualified board or exchange, (2) the contract must be traded in the interbank market, and (3) the contract must be entered into at arm’s length at a price determined by reference to the price in the interbank market. According to the legislative history to Code Sec. 1256(g)(2), Congress believed that interbank currency contracts that meet all of the conditions of Code Sec. 1256(g)(2) should be subject to the same rules as regulated futures contracts (RFCs) because they are economically comparable:

Foreign currency contracts.—Trading in foreign currency for future delivery is conducted through

regulated futures contracts, and is also conducted through contracts negotiated with any one of a number of commercial banks which comprise an informal market for such trading (*bank forward contracts*). Bank forward contracts differ from regulated futures contracts in that they are private contracts in which the parties remain entitled to performance from each other. They further differ from regulated futures contracts in that they do not call for daily variation margin to reflect market changes, and in that the interbank market has no mechanism for settlement terminating a taxpayer’s position prior to the delivery date ... Although bank forward contracts differ from regulated futures contracts, the volume of trading through forward contracts in foreign currency in the interbank market is substantially greater than foreign currency trading on futures exchanges, and prices are readily available. Such contracts are economically comparable to regulated futures contracts in the same currencies and are used interchangeably with regulated futures contracts by traders. [Emphasis added.]¹⁴

Based on the legislative history to Code Sec. 1256, the “foreign currency contract” category had been consistently interpreted by the IRS to *exclude* OTC currency options and swaps. In LTR 8818010, for example, the IRS concluded that foreign currency *swap* contracts that involved periodic payments between the parties during the term of the agreement based on a notional amount of a specified currency multiplied by specified interest rates and an exchange of the notional amount of the currencies at the end of the transaction were not foreign currency contracts within the meaning of Code Sec. 1256.¹⁵ In FSA 200025020, the IRS concluded that OTC currency *option* contracts are not foreign currency contracts pursuant to Code Sec. 1256(g)(2).¹⁶

Notwithstanding what appears to be clear legislative intent to limit Code Sec. 1256(g)(2) to bank forward contracts, the IRS reversed its prior views on OTC currency options in Notice 2003-81.¹⁷ This notice describes a tax avoidance transaction involving offsetting foreign currency options and identified such transactions, and those substantially similar to it, as “listed transactions” for purposes of Reg. §§1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2). Without offering any analysis, Notice 2003-81 simply concluded that OTC currency options were included in the definition of foreign currency contracts under Code Sec. 1256(g)(2).

Fortunately, the uncertainty resulting from the IRS's confusing position in Notice 2003-81 was resolved by Notice 2007-71.¹⁸ This Notice modifies and supplements Notice 2003-81, by correcting a statement in the "Facts" portion to provide that "*The taxpayer takes the position* that the purchased options are foreign currency contracts within the meaning of §1256(g)(2)(A) of the Internal Revenue Code and §1256 contracts within the meaning of §1256(b)." [Emphasis added.] As to the Code Sec. 1256 classification of OTC currency options, the IRS stated in Notice 2007-71 that it does not believe that such options are Code Sec. 1256 contracts, and that it intends to challenge any such characterization by taxpayers.¹⁹

Notice 2007-71 also provides Code Sec. 7805(b) relief to taxpayers that adopted mark-to-market accounting for OTC currency options under Code Sec. 1256(a) in reasonable reliance on Notice 2003-81. Relief is not granted, however, with respect to options entered into in transactions that are the same or substantially the same as those described in Notice 2003-81. Further, Code Sec. 7805(b) relief is not granted with respect to options entered into in any transaction identified as a listed transaction for purposes of Reg. §§1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2).

Classification of OTC currency options and swaps as Code Sec. 1256 contracts—or not—is significant in light of the mark-to-market accounting rules under Code Sec. 1256(a). By contrast, OTC currency derivatives that do not meet the definition of a Code Sec. 1256 contract generally result in gain or loss on a "when realized" basis. In either case, however, such positions would result in ordinary gains and losses by reason of Code Sec. 988, which generally trumps the 60/40 capital gain or loss rule under Code Sec. 1256(a)(3).²⁰

Code Sec. 1256 contract classification also has implications under the Code Sec. 1092 straddle rules. For example, if a Code Sec. 1256 contract is part of a tax straddle with an offsetting position that is not a Code Sec. 1256 contract, the one-way timing whipsaw rule for "mixed straddles" could apply. Among other consequences, this would mean that if the foreign currency contract goes up in value and the offsetting position declines in value, the mark-to-market rule would require current recognition of gain on the foreign currency contract, whereas losses on the offsetting position would not be similarly marked-to-market. On the other hand, if the Code Sec. 1256 contract position in a mixed straddle declines in value, the mark-to-market loss is likely to be deferred

by reason of Code Sec. 1092, resulting in a one-way timing whipsaw in favor of the IRS.

Beyond the specific issue of whether OTC currency options and other forms of OTC currency contracts (other than bank forwards) are Code Sec. 1256 contracts, Notice 2007-71 is also important in that it shows the significance of legislative history on the proper interpretation of financial product tax matters. Too often in recent years the legislative history of a particular financial product Code section has seemingly been ignored in attempting to determine the proper scope of a provision. This is an especially important step in light of the fact that very often Congress intended to deal with a specific financial product or transaction and, absent specific language applying the provision to financial products in general, Congress could not have intended for the provision to apply broadly, especially in the case of transactions that were not even available at the time the provision was adopted.²¹

Prepaid Forward Contracts and Contingent Exchange Traded Notes

As a general rule, an instrument issued in the form of a promissory note will be taxed as a debt instrument and, depending on its terms, potentially subject to the accretion principles of Code Secs. 1272 through 1275. Recently, there have been a number of promissory note issuances (referred to as "exchange traded notes") that, depending on whether and to what extent the principal amount is "protected," have been characterized by issuers and holders as prepaid forward contracts. For example, consider an exchange traded note where the entire return is tied to the performance of a specified index (meaning, there is no coupon paid on the note during its term). To the extent the note's principal is not "protected" (meaning the principal amount payable at maturity is based solely on the performance of the reference index), such notes have been characterized as prepaid forward contracts for federal income tax purposes rather than as debt.²²

A prepaid forward contract is a forward contract in which the purchaser agrees to pay the forward purchase price in advance of the future delivery of the reference property by the seller. Although the amount of the prepayment generally reflects the actual forward price of the underlying property discounted to reflect

the time value of money, as a general matter neither party to a prepaid forward recognizes any income or deduction until the forward contract matures. Back in 2001, the New York State Bar Association Tax Section had suggested potential changes to the timing of income and deductions resulting from prepaid forward contracts, but no changes were forthcoming from the IRS as a result of these proposals.²³ By characterizing an exchange traded note as a prepaid forward contract rather than debt for federal income tax purposes, a holder would generally not recognize any taxable income or loss from the instrument prior to its maturity. In addition, an individual holder would be entitled to treat any resulting income from the exchange traded note as long-term capital gain to the extent the instrument was held for the long-term capital gains holding period.²⁴

In an attempt to end the prepaid forward contract characterization of certain exchange traded notes, Rev. Rul. 2008-1, issued on December 7, 2007, addresses the characterization of exchange traded notes and prepaid forward contracts where the underlying property (or index) is a foreign currency. The facts in Rev. Rul. 2008-1 assume that on January 1, 2007, the spot rate of exchange of U.S. dollars for euros was \$1 = €0.75, and that on the same date, "Holder" (the forward purchaser) delivered \$100 to "Issuer" (the forward seller) in exchange for the Issuer's obligation to deliver to Holder, on the forward contract maturity date, the U.S. dollar equivalent of an amount of euros (the "U.S. Dollar Equivalent Amount"). The U.S. Dollar Equivalent Amount is determinable on the maturity date and is the sum of the following amounts translated into U.S. dollars at the spot rate on such date: (1) €75 and (2) an amount of euros calculated by reference to a compound stated rate of return applied to €75 from the date the contract was entered into through the maturity date.

Rev. Rul. 2008-1 notes that the legal remedies provided in the contract are not materially different than legal remedies associated with instruments that are debt for federal income tax purposes. Rev. Rul. 2008-1 also notes the contingent nature of the principal repayment by stating that the U.S. Dollar Equivalent Amount payable by the Issuer to the Holder at contract maturity may be significantly less than \$100.

Although not specifically stated as such, the issue being dealt with in Rev. Rul. 2008-1 is whether the forward purchaser (Holder) should be required to accrue income during the term of the instrument. To

the extent that the instrument at issue is properly characterized as a forward contract for federal income tax purposes rather than indebtedness, a nondealer forward purchaser would not, under current law, be required to mark the contract to market or to otherwise accrue income prior to maturity.²⁵ If, on the other hand, the instrument is properly characterized as a debt instrument for federal income tax purposes, the Holder would then be subject to the accrual principles of Code Secs. 1271 through 1275.

Without offering a detailed analysis, Rev. Rul. 2008-1 observes that while nonfunctional currency is generally considered to be "property" for federal income tax purposes, including the straddle rules of Code Sec 1092, that nonfunctional currency can also be treated like "money" for other purposes, such as determining the amount and timing of interest that accrues on debt.²⁶ By viewing nonfunctional currency as money (rather than property), the IRS concluded that, under the terms of the instrument, the Holder delivers the U.S. dollar equivalent of €75 at the start of the contract, and at maturity the Issuer is required to pay the U.S. dollar equivalent of €75, plus the U.S. dollar value at maturity of a return based on euro interest rates. According to the IRS, the fact that intervening currency fluctuations may cause the amount of U.S. dollars that the Holder receives at maturity to be less than the amount of U.S. dollars that the Holder paid upon entering into the instrument (*i.e.*, the contingent nature of the principal repayment) does not affect the characterization of the instrument as indebtedness.

In a companion release (Notice 2008-2), the IRS and the Treasury requested public comments with respect to issues that arise in connection with other forms of exchange traded notes and prepaid forward contracts, including instruments where the return is based on an equity or a commodity index.²⁷ In particular, the IRS and the Treasury are considering whether the parties to such exchange traded notes and prepaid forward contracts should be required to accrue income/expense during the term of the transaction, if the instrument is *not* properly characterized as indebtedness for federal income tax purposes. The IRS and the Treasury are also considering a number of other issues associated with these transactions, including but not limited to the following:

- The appropriate methodology for accruing income or expense, if deemed appropriate (for example, a mark-to-market methodology or a method resembling the noncontingent bond method set forth in Reg. §1.1275-4)

- How an accrual regime might be designed so that it does not inappropriately or inadvertently cover routine commercial transactions involving property sales in the ordinary channels of commerce
- The appropriate character (capital versus ordinary, and if ordinary, whether interest) of any income accruals required under such an accrual regime, as well as the character of amounts less than, or in excess of, these accruals
- Whether the tax treatment of prepaid forward transactions should vary depending on the nature of the underlying asset (for example, stocks versus commodities)
- Whether the tax treatment should vary depending on whether the transactions are (i) executed on a futures exchange (and are not otherwise subject to Code Sec. 1256), or (ii) memorialized in an instrument that is traded on a securities exchange
- Whether the constructive ownership rules of Code Sec. 1260 apply to prepaid forward contracts and similar transactions
- The degree to which such transactions (and any income accruals that may be mandated) should be taxed under Code Secs. 871 and 881
- How the income with respect to such instruments should be treated for purposes of Code Sec. 954 (for example, as income equivalent to interest or gains from property that does not give rise to income)
- How investments in such contracts should be treated under Code Sec. 956

Apparently concerned that the IRS and the Treasury may not act quickly enough, if at all, prepaid derivatives and exchange traded notes are the subject of legislation proposed on December 19, 2007. Specifically, H.R. 4912 would, if adopted, implement new Code Secs. 1289 and 1290 addressing the taxation of "prepaid derivatives." Under the proposed legislation, a "prepaid derivative" is defined as any contract with a term longer than one year from the date of issuance (1) where "there is no substantial likelihood that the taxpayer will be required to pay any additional amount under the contract" and (2) which is a derivative financial instrument with respect to certain securities, commodities or financial indices. Exceptions would be provided for instruments properly treated as actual tax ownership of the underlying property (stock, debt or an interest in a partnership), instruments that are part of a Code Sec. 1260 con-

structive ownership transaction, Code Sec. 1256(e) hedging transactions, notional principal contracts and certain qualifying options.

If an instrument is characterized as a prepaid derivative under the proposed legislation, the holder would be required to include in gross income during the term of the instrument an amount equal to "the holder's *interest accrual amount* with respect to such contract for the taxable year." [Emphasis added.]²⁸ Any amount included in gross income under proposed Code Sec. 1289 would (1) be treated as interest income and (2) increase the holder's basis in the derivative contract itself. Note that the proposed legislation does not address the tax consequences to the issuer of a prepaid derivative contract.

Although Rev. Rul. 2008-1 is aimed specifically at foreign currency denominated exchange traded notes, this ruling may have broader implications for determining whether debt instruments with contingent principal are properly characterized as indebtedness, or as derivatives, for federal income tax purposes. Without offering any analysis of the traditional factors of debt characterization, Rev. Rul. 2008-1 seemingly disregards what has traditionally been thought of as one of the more important factors, which is whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future. It is unclear how the IRS's view in Rev. Rul. 2008-1 relating to contingent principal will be applied generally to the analysis of whether or not an instrument may be characterized as debt even though there may not (by reason of a contingency) be an unconditional obligation to pay a sum certain at maturity.

Further, Notice 2008-1 and the proposed legislation described above indicate that some effort may be made to impose accrual principles on prepayments associated with derivatives beyond the current rules for notional principal contracts set out in Reg. §1.446-3. One can only hope that any such rules will be thoughtfully adopted.

Conclusions

Calendar year 2007 included a number of important developments relating to financial product taxation that potentially have broad implications beyond the targeted transactions or products. As noted above, the IRS's single-versus-separate instrument analysis in Chief Counsel Memorandum

dum AM 2007-0014 should be relevant for many common financial product transactions involving two or more instruments. Similarly, the IRS's willingness in Notice 2007-71 to look to legislative history and Congressional intent for guidance is a promising development.

Finally, and perhaps most importantly, Rev. Rul. 2008-1 is potentially the first step in the process of revamping a number of long-standing financial product rules in an attempt to impose accrual principles on prepayments. We expect 2008 will bring a number of additional developments on this topic.

ENDNOTES

¹ AM 2007-0014 (July 20, 2007).

² Tax integration is also permitted for certain qualifying foreign currency hedging transactions under Code Sec. 988(d) and Reg. §1.988-5. All reference to the Code are to the Internal Revenue Code of 1986 ("the Code"), as amended.

³ In addition to the basic rules described above, a taxpayer may take advantage of Reg. §1.1275-6 only if the following requirements are met:

- Same day identification exists under Reg. §1.1275-6(e).
- The parties to the hedge are not related, or, if they are related, the party proposing the hedge uses a mark-to-market method of accounting for the hedge and all similar or related transactions.
- The same taxpayer enters into both the hedge and the QDI.
- If the taxpayer is a foreign person engaged in a U.S. trade or business, all items of income and expense (other than interest expense subject to Reg. §1.882-5) are effectively connected with the U.S. trade or business for the period of the QDI had Reg. §1.1275-6 not applied.
- Neither the hedge or the QDI nor any other debt instrument that is part of the same issue as the QDI was part of an integrated transaction with respect to the taxpayer or otherwise legged out of in the 30 days preceding the issue date of the QDI.
- The taxpayer issues the QDI on or before the date on which the taxpayer makes or receives the first payment on the Reg. §1275-6 hedge.
- Neither the hedge nor the QDI may have previously been a part of a Code Sec. 1092 straddle.

⁴ Reg. §1.1275-6(b)(2)(i).

⁵ In limited circumstances, the IRS has the authority to deem a taxpayer to have made an integration election. See Reg. §1.1275-6(c)(2).

⁶ Reg. §1.1275-6(f).

⁷ Reg. §1.1275-6(a). ("The rules of this section affect only the taxpayer who holds (or issues) the qualifying debt instrument and enters into the hedge.")

⁸ Reg. §1.1275-6(f)(4).

⁹ Reg. §1.1272-1(b)(1)(i).

¹⁰ Other issues considered by the IRS in the

Chief Counsel Memorandum include a discussion of whether the OID anti-abuse rule in Reg. §1.1275-2(g) applied to the transaction potentially allowing the IRS to either disallow integration of the notes with the purchased options or to require integration of the written options as well, along with a general discussion of whether or not the separate nature of the options might be disregarded if the option premiums are not fairly priced, or if the premium paid for the purchased options was meaningfully greater than the premium received for the written options.

¹¹ Rev. Rul. 88-31, 1988-1 CB 302. Rev. Rul. 2003-97, 2003-2 CB 380.

¹² *Supra* note 1.

¹³ See William R. Pomierski, Current Federal Tax Developments, *Code Sec. 1256 Considerations for ICE Futures and Beyond*, 6 J. TAX'N FINANCIAL PRODUCTS 4 (2007), at 5.

¹⁴ H.R. COMM. REP. 97-794 at 23 (2d Sess. 1982). See also S. REP. NO. 97-592 (2d Sess. Jan. 1, 1982). See also H.R. CONF. REP. NO. 986, at 24 (2d Sess. 1982), which describes foreign currency forward contracts under the heading "Bank Forward Contracts."

¹⁵ According to the IRS, "Currency swap contracts are significantly different than bank forward contracts in the way interest rates differentials in the currencies which are the subject of the contracts are accounted for. Currency swap contracts typically account for interest rate differentials through a present and continuing exchange of notional interest payments over the life of the contracts while bank forward contracts account for such difference upon maturity. Given this significant difference between bank forward contracts and currency swap contracts and *the failure by Congress* in the legislative history of the Technical Corrections Act of 1982 and the Tax Reform Act of 1986 ("the 1986 Act") to indicate its intention to include currency swaps within the definition of foreign currency contract, we conclude that the currency swap agreements fail to satisfy the requirements of section 1256(g)(2)(A)(ii) and (iii). Accordingly, we hold that the currency swap agreements are not section 1256 contracts." [Emphasis added.]

¹⁶ FSA 200025020 (Mar. 17, 2000). ("Although the definition of a foreign currency contract provided in §1256(g)(2) may be

read to include a foreign currency option contract, the legislative history of the Technical Corrections Act of 1982 ("TCA"), P. L. 97-448, 1983-1 C.B. 451, which amended §1256 to include foreign currency contracts, indicates that the Congress intended to extend §1256 treatment only to foreign currency forward contracts that are traded on the interbank market. See S. REP. NO. 592, 97th Cong., 2d Sess., reprinted in 1983-1 C.B. 475, 485-486; H.R. REP. NO. 986, 97th Cong., 2d Sess., reprinted in 1983-1 C.B. 498, 503-04. There is no indication that foreign currency option contracts were contemplated for inclusion in the statutory definition of a forward currency contract in §1256(g)(2)(A).")

¹⁷ Notice 2003-81, IRB 2003-51, 1223.

¹⁸ Notice 2007-71, IRB 2007-35, 472.

¹⁹ According to the IRS, there is no indication that Congress intended to extend the definition of "foreign currency contract" to foreign currency options. That conclusion is confirmed by the Legislative History to Code Sec. 988(c)(1)(E), enacted by the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647), which indicates that a foreign currency option is not a foreign currency contract as defined in Code Sec. 1256(g)(2).

²⁰ Code Sec. 988(a)(1)(A) and Code Sec. 988(b)(3). Note that Code Sec. 1256 contracts that are considered Code Sec. 988 transactions will continue to be subject to the Mark-to-Market Rule (unless trumped by some other provision of the Code), notwithstanding the ordinary gain or loss characterization resulting from Code Sec. 988. Contrast Code Sec. 988(c)(1)(D)(i) for regulated futures contracts and nonequity options.

²¹ See, for example, *D.E. Gantner*, CA-8, 90-2 USTC ¶50,335. *Aff'g*, 92 TC 192 (1989).

²² In Notice 94-47, 1994-1 CB 357, the IRS set out the following factors to be considered in making the determination as to whether an instrument should be characterized as debt for federal income tax purposes: (a) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future; (b) whether holders of the instruments possess the

right to enforce the payment of principal and interest; (c) whether the rights of the holders of the instruments are subordinate to rights of general creditors; (d) whether the instruments give the holders the right to participate in the management of the issuer; (e) whether the issuer is thinly capitalized; (f) whether there is identity between holders of the instruments and stockholders of the issuer; (g) the label placed upon the instruments by the parties; and (h) whether the instruments are intended to be treated as debt or equity for nontax purposes, including regulatory, rating agency, or financial accounting purposes.

²³ See Robert A. Jacobs, *NYSBA Suggests Changes to Timing and Character Rules for Prepaid Forwards and Options*, 2001 TNT 64-23 (Mar. 26, 2001).

²⁴ See generally Code Sec. 1234A. The con-

clusions reached in Rev. Rul. 2008-1 that the instrument is debt also has the effect of preventing holders from electing out of ordinary treatment under Code Sec. 988(a)(1)(B), which provides that except as otherwise provided in regulations, a taxpayer may elect to treat any foreign currency gain or loss attributable to a forward contract, a futures contract or option described in Code Sec. 988(c)(1)(B) (iii), which is a capital asset in the hands of the taxpayer and which is not a part of a straddle (within the meaning of Code Sec. 1092, without regard to paragraph (4) thereof) as capital gain or loss (as the case may be) if the taxpayer makes such election and identifies such transaction before the close of the day on which such transaction is entered into (or such earlier time as the Secretary may prescribe).

²⁵ Assuming either that the forward seller is

not an interbank market participant, or that the forward contract is not entered into at a price determined by reference to the price in the interbank market, the forward contract would not be considered a Code Sec. 1256 contract under Code Sec. 1256(g)(2), and therefore would not be subject to mark-to-market tax accounting under Code Sec. 1256(a). If properly characterized as a derivative financial instrument, rather than debt, it is also assumed that a prepaid forward contract would not meet the definition of a notional principal contract, and therefore would not be subject to the accrual principles of Reg. §1.446-3.

²⁶ See Reg. §1.988-2(b)(2).

²⁷ Notice 2008-2, IRB 2008-2, 252.

²⁸ If adopted, this legislation would apply to prepaid derivative contracts acquired after the date of enactment.

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