

**Office of Chief Counsel
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memorandum**

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to: Marc Shapiro
Senior Attorney
Suite 1200 One Cleveland Center
Cleveland, OH 44114
(Large Business & International)

from: William E. Blanchard, Senior Technician Reviewer, CC:FIP:B03
Office of Associate Chief Counsel
(Financial Institutions & Products)

subject: Unamortized hedge gain on debt and I.R.C. § 108(i) election

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
Counterparty	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
<u>A</u> Amount	=
<u>B</u> Amount	=
<u>C</u> Amount	=
<u>D</u> Amount	=
<u>E</u> Amount	=
<u>F</u> Amount	=
<u>G</u>	=

H =
I =
J =

ISSUE

Whether Treas. Reg. § 1.446-4 allows Taxpayer to defer the recognition of the portion of the unamortized hedge gain from an anticipatory interest rate hedge allocable to repurchased Debentures when the Taxpayer elects under I.R.C. § 108(i) to defer the recognition of cancellation of indebtedness income realized upon the repurchase of the Debentures.

CONCLUSION

Based on the information provided to our office, we believe that Treas. Reg. § 1.446-4 does not allow Taxpayer to defer the recognition of the portion of the unamortized hedge gain from an anticipatory interest rate hedge allocable to the repurchased Debentures when the Taxpayer elects under I.R.C. § 108(i) to defer the recognition of cancellation of indebtedness income realized upon the repurchase of the Debentures.

FACTS

On Date 2, Taxpayer issued A Amount of junior subordinated debentures, each with a principal amount of \$1,000, for an issue price of B Amount per debenture (“Debentures”). The Debentures had a final stated maturity date of Date 5. The interest rate on the Debentures from issuance until Date 4, is G% per annum, payable semiannually. Beginning Date 4 and through Date 5, interest will be payable quarterly at a rate equal to three-month LIBOR plus H% per annum.

On Date 1, prior to issuance of the Debentures, Taxpayer entered into a ten-year interest rate swap with Counterparty to lock-in interest rates for the fixed rate term of the Debentures. The anticipatory interest rate hedge was identified as a hedge of the Debentures for both book and tax purposes (“Hedge”). The Hedge required Taxpayer to pay Counterparty semiannually an amount equal to I% per annum multiplied by a notional principal amount of A Amount. Counterparty was required to pay Taxpayer quarterly an amount equal to three-month LIBOR multiplied by a notional principal amount of A Amount. The Hedge was intended to protect Taxpayer from changes in interest rates from the inception of the Hedge until the completion of the anticipated issuance of the Debentures.

The Hedge was terminated on the date of the Debenture's issuance, Date 2, and Counterparty paid a termination payment of C Amount, resulting in gain on the Hedge to Taxpayer of D Amount ("Hedge Gain"). Taxpayer amortized Hedge Gain over the ten years for both book and tax purposes.

On Date 3, Taxpayer made an offer to purchase its Debentures at a price below the principal amount due on the Debentures. Holders accepted the offer on J% of the outstanding Debentures, resulting in cancellation of indebtedness income in an amount of E Amount ("COD Income"). The unamortized Hedge Gain that was allocable to the repurchased Debentures was E Amount. For book purposes, Taxpayer will recognize both COD Income and the Hedge Gain allocable to the repurchased Debentures during the year of repurchase. For tax purposes, however, Taxpayer has elected to defer the recognition of the COD income under I.R.C. § 108(i). Taxpayer argues that under Treas. Reg. § 1.446-4 it can defer the recognition of the unamortized Hedge Gain allocable to the repurchased Debentures until the years the COD income is recognized under I.R.C. § 108(i).

LAW

In general, Treas. Reg. § 1.446-4 provides that a hedging transaction as defined in Treas. Reg. § 1.1221-2(b) (whether or not the character of gain or loss from the transaction is determined under Treas. Reg. § 1.1221-2) must be accounted for under the rules of Treas. Reg. § 1.446-4. To the extent that provisions of any other regulations governing the timing of income, deductions, gain, or loss are inconsistent with the rules of Treas. Reg. § 1.446-4, the rules of Treas. Reg. § 1.446-4 control.

Treas. Reg. § 1.1221-2(b) defines a hedging transaction, in part, as a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer. Treas. Reg. § 1.1221-2(c) provides rules to determine whether a transaction is a hedging transaction.

Under Treas. Reg. § 1.446-4(b), the method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, 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. Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. In the case of many hedging transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.

Under Treas. Reg. § 1.446-4(c), for any given type of hedging transaction, there may be more than one method of accounting that satisfies the clear reflection requirement of Treas. Reg. § 1.446-4(b). A taxpayer is generally permitted to adopt a method of accounting for a particular type of hedging transaction that clearly reflects the taxpayer's income from that type of transaction.

Treas. Reg. § 1.446-4(e) provides requirements and limitations on the taxpayer's choice of method of accounting for certain hedging transactions. Even if these rules are satisfied, however, the taxpayer's method, as actually applied to the taxpayer's hedging transactions, must clearly reflect income by meeting the matching requirement of Treas. Reg. § 1.446-4(b). Under Treas. Reg. § 1.446-4(e)(4), gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. A hedge of a debt instrument that provides for interest to be paid at a fixed or a qualified floating rate, for example, generally is accounted for using constant yield principles. Thus, assuming that a fixed rate or qualified floating rate instrument remains outstanding, hedging gain or loss is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. For example, gain or loss realized on a transaction that hedged an anticipated fixed rate borrowing for its entire term is accounted for, solely for purposes of this section, as if it decreased or increased the issue price of the debt instrument.

Treas. Reg. § 1.446-4(f) provides that the rules of Treas. Reg. § 1.446-4 govern the timing of income, deduction, gain, or loss on hedging transactions but do not affect the type or character of income, deduction, gain, or loss produced by the transaction. For example, the rules of Treas. Reg. § 1.446-4(e)(4) do not increase or decrease the interest income or expense of a taxpayer that hedges a debt instrument or liability.

In Rev. Rul. 2002-71, 2002-2 C.B. 763, contemporaneously with the issuance of a ten-year fixed-rate debt instrument issued by a taxpayer, the taxpayer entered into a fixed to floating rate notional principal contract (NPC) to hedge the interest rate on the first five years of the debt instrument. The taxpayer terminated the NPC on the last day of the second year. Because the NPC would have hedged the interest rate on the debt instrument for the next three years and the termination payment represents the present value of the extinguished rights and obligations under the NPC for these years, the ruling holds that any termination payment was to be taken into account over the next three years to clearly reflect income in accordance with the matching requirement of Treas. Reg. § 1.446-4. In the fourth year, the taxpayer retired the debt instrument. The ruling holds that the remaining gain or loss from the termination of the NPC is recognized in the fourth year in order to 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 being hedged.

I.R.C. § 108(i) allows, at the election of the taxpayer, income from the discharge of indebtedness in connection with the reacquisition after December 31, 2008 and before January 1, 2011, of an applicable debt instrument to be includible in gross income ratably over the 5-taxable-year period beginning with the fifth or fourth taxable year following the taxable year in which the reacquisition occurs, whichever is applicable. The preamble to TD 9497 provides that the IRS and Treasury Department believe that the deferral rules of I.R.C. § 108(i) generally are intended to facilitate debt workouts and to alleviate taxpayer liquidity concerns by deferring the tax liability associated with COD income. In general, COD income is determined based on the adjusted issue price of a debt instrument. See Treas. Reg. § 1.61-12(c)(2)(ii).

ANALYSIS

Treas. Reg. § 1.446-4(e)(4) requires that gain or loss from a transaction that hedges a debt instrument to be issued must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. In Rev. Rul. 2002-71, the Service applied Treas. Reg. § 1.446-4(e)(4) to a hedge that only managed interest rate risk for the first five years of a ten year debt instrument. Accordingly, the ruling held that gain or loss from the early termination of the hedge at the end of year two was required to be spread over the next three years as that was the period to which the hedge related and sought to reduce risk. In this case, the Taxpayer entered into the anticipatory Hedge to manage interest rate risk by locking-in a borrowing rate on the Debentures for the first ten years of the life of the Debentures. As a result, Taxpayer amortized the Hedge Gain over the period to which it was locking-in its fixed rate of interest. Taxpayer's accounting for the Hedge Gain is fully consistent with the matching principles of Treas. Reg. § 1.446-4 as the Hedge Gain is taken into account and matched against the additional interest expense that Taxpayer sought to hedge against as a result of concern over increasing interest rates during the period before the pricing of its Debentures.

When the Debentures were repurchased with no related reissuance, the term of the Debentures ended, and interest that had been effectively reduced by the Hedge of those Debentures no longer existed. Thus, upon repurchase, the item being hedged ceased to exist, and to clearly reflect income, the unamortized Hedge Gain allocable to the repurchased Debentures should be recognized in the year in which the Debentures were repurchased. See Treas. Reg. § 1.446-4(e)(4) and Rev. Rul. 2002-71 (the matching rules do not contemplate that the gain or loss on a debt hedge continues to be spread or amortized once the hedged item is terminated).

Based on its election under I.R.C. § 108(i), Taxpayer would like to change how it is matching the Hedge Gain so that the unamortized Hedge Gain allocable to the repurchased Debentures would now be matched to COD income (not interest

expense). The Taxpayer's election under I.R.C. § 108(i), however, should not change the conclusion that the unamortized Hedge Gain allocable to the repurchased Debentures should be recognized in the year of repurchase.

First, based on the information provided, there is no connection between the Hedge Gain and the COD income to require matching of the two in this case. Treas. Reg. § 1.446-4 clearly requires that the Hedge Gain be spread over the period to which the Hedge relates. In this case, the Hedge only related to the fixed rate term of the Debentures, so spreading the Hedge Gain to a different period and to a period even longer than the ten year fixed rate period being hedged is contrary to the regulations. Second, the COD income does not appear to have arisen from changes in interest rate risk, and the purpose of the anticipatory Hedge was to manage interest rate risk. Third, as noted above, the matching rules in Treas. Reg. § 1.446-4 do not contemplate that gain on a debt hedge continues to be spread or amortized once the hedged item is terminated.

For the above reasons, Treas. Reg. § 1.446-4 should not allow Taxpayer to defer the recognition of the unamortized Hedge Gain allocable to the repurchased Debentures if the Taxpayer elects under I.R.C. § 108(i) to defer the COD income realized upon the repurchase of the Debentures.

Please call (202) 622-5772 if you have any further questions.