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Unit Name	Disposition of a Portion of an Integrated Hedge
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Issue and Transaction Overview

Disposition of a Portion of an Integrated Hedge

- A taxpayer with the US dollar as its functional currency borrows funds in a currency other than the US dollar. Borrowing in the foreign currency subjects the taxpayer to foreign currency risk, which the taxpayer will wish to limit or mitigate. To mitigate the foreign currency risk on the underlying debt instrument, the taxpayer enters into multiple foreign currency hedges related to the debt instrument. For tax purposes, the foreign currency denominated debt instrument is integrated with the foreign currency hedges resulting tax treatment such that foreign exchange gains or losses on the hedges offset foreign exchange loss or gain on the debt instrument.
- In general, IRC § 988(d) and Treas. Reg. § 1.988-5(a) and Treas. Reg. § 1.988-5T(a) provide detailed rules that permit the integration of a qualifying debt instrument (QDI) with hedges described in these Treasury Regulations. A result of this integration is to create a synthetic debt instrument or Qualified Hedging Transaction (QHT). No foreign currency (FX) gain or loss is recognized on the QDI or the hedge for the period that it is part of the QHT.
- If a taxpayer disposes of a portion of the integrated hedge prior to the maturity of the QHT, it is treated as legging out of the integrated treatment. The QDI and the remaining components of the hedge are treated, for U.S. tax purposes, as sold for the FMV on the date of the disposition of the disposed portion of the integrated hedge.
- Any FX gains or losses on the QDI and the remaining components of the integrated hedge from the date of the integrated treatment to the leg-out date are recognized on the date of the legging out transaction. See section Treas. Reg. 1.988-5(a)(6)(ii) . For legging out of integrated treatment on or after September 6, 2012 and before or on September 4, 2015, Treas. Reg. 1.988-5T(a)(6)(ii) will apply.

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Issue and Transaction Overview (cont'd)

Disposition of a Portion of an Integrated Hedge

- Assume that the debt instrument and the hedges have been properly integrated under the requirements of Treas. Reg. 1.988-5, or Treas. Reg. 1.988-5T, which create a QHT. If all or any part of the debt instrument or hedge is disposed of prior to the maturity of the QHT, this type of transaction is referred to as "legging out" of the integrated treatment.
- As the value of the foreign currency in which the underlying debt instrument denominated increases, this will result in a foreign currency loss on the debt instrument and foreign currency gains on the related hedges. In general, legging out of the integrated transaction will result in tax treatment such that all of the remaining components of the hedge and the underlying debt instrument are treated as sold for their fair market value on the date of the legging out transaction. Accordingly such a deemed disposition would trigger a recognition event for the disposed hedge, the underlying debt instrument, and the remaining component of the hedge.
- This unit discusses "legging out" of an integrated hedging transaction in cases where a QHT under Treas. Reg. 1.988-5 and Treas. Reg. 1.988-5T, consists of multiple foreign currency hedges. The tax issue is whether such "legging out" of a foreign currency hedge requires a recognition event for U.S. tax purposes (e.g. recognition of either foreign currency gain or loss).

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Transaction and Fact Pattern

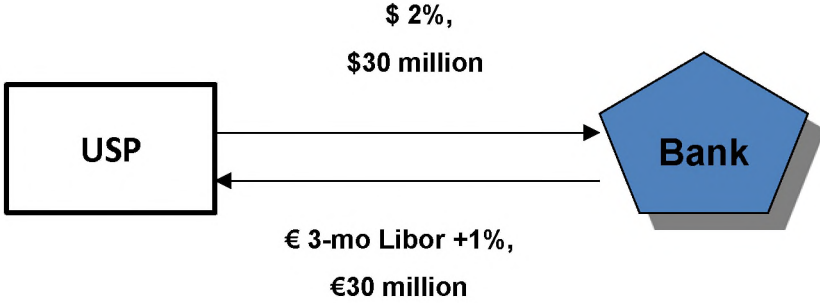

Disposition of a Portion of an Integrated Hedge

Diagram of Transaction	Facts
<p><u>Illustration of the Euro loan</u></p> <pre> graph LR USP[USP] Counterparty[Unrelated counterparty] Counterparty -- "€50 million Note, 3-mo Libor +1%" --> USP USP -- "€50 million" --> Counterparty </pre>	<ul style="list-style-type: none"> ▪ The U.S. taxpayer (USP) has the U.S. dollar as its functional currency. The USP borrows €50 million at a 3-mo LIBOR + 1% for 5 years from an unrelated counterparty on 1/1/2010. 3-mo LIBOR rate on 1/1/2010 is 0.25%. The interest is payable on December 31 of each year with no principal payment due until maturity on 12/31/2015. Assume that the spot rate on 1/1/2010 is €1:\$1, and the taxpayer exchanges €50 million for \$50 million. Borrowing in the Euro subjects the taxpayer to foreign currency risk. Consequently the taxpayer enters into two 5-year currency swaps, with differing notional principal amounts that aggregate to the €50 million borrowed from an unrelated party. ▪ The currency swaps allow the taxpayer to lock in the U.S. dollar cost of each interest and principal payment in Euros thus removing its foreign currency risk. The taxpayer integrates the swaps with the Euro loan which creates a qualified hedging transaction (QHT) under IRC Sections 988(d) and Treas. Reg. 1.988-5(a) and Treas. Reg. 1.988-5T(a).

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Transaction and Fact Pattern (cont'd)

Disposition of a Portion of an Integrated Hedge

Diagram of Transaction	Facts
<p><i>Illustration of the currency swaps.</i></p> <p><i>The Swap1</i></p>  <p><i>The Swap2</i></p> 	<p>The terms of the swaps are as follows:</p> <ul style="list-style-type: none"> ▪ In the Swap1 agreement, the taxpayer exchanges with the Bank interest payments of 2% of \$30 million in US dollars and a principal amount of \$30 million; in exchange the Bank pays the taxpayer interest payments of Euro 3-mo LIBOR + 1% of €30 million in Euros and a principal amount of €30 million. ▪ In the Swap2 agreement, the taxpayer exchanges with the Bank interest payments of 2% of \$20 million in US dollars and a principal amount of \$20 million; in exchange the Bank pays the taxpayer interest payments of Euro 3-mo LIBOR + 1% of €20 million in Euros and a principal amount of €20 million.

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Transaction and Fact Pattern (cont'd)

Disposition of a Portion of an Integrated Hedge			
Diagram of Transaction		Facts	
<i>As the value of the Euro increases to €1:\$1.20 from €1:\$1</i>			
	<i>The Swap1</i>	<i>The Swap2</i>	<ul style="list-style-type: none"> As the value of the Euros increases to €1:\$1.2 on 12/31/2012, the taxpayer is in a FX loss position of \$10 million on the Euro loan. It would take the taxpayer \$60 million (€50 million x \$1.2) to repay the Euro loan with the principal amount equivalent to \$50 million at the time of borrowing. In contrast, the taxpayer has unrealized FX gain on the Swap1 of \$6 million [(€30 million x \$1.2) - \$30 million] and FX gain on the Swap2 of \$4 million [(€20 million x \$1.2) - \$20 million]. For purposes of this example, we ignore time value of money and changes in interest rates. In this transaction and fact pattern, the taxpayer integrates the Euro loan with the Swaps. The integration creates a qualified hedging transaction. Swap1 is disposed of on 12/31/2012, and such disposition is considered as legging out of the integrated treatment.
<i>FX Gain</i>	\$6 million (\$36 - \$30)	\$4 million (\$24 - \$20)	
→			
	<i>The Euro Loan</i>		
<i>FX Loss</i>	(\$10 million) (\$50 - \$60)		

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Summary of Potential Issues

Disposition of a Portion of an Integrated Hedge	
<u>Issue 1</u>	Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the disposed hedge.
<u>Issue 2</u>	Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the underlying debt instrument.
<u>Issue 3</u>	Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the remaining component of the hedge, such that it is treated as sold for its Fair Market Value (FMV).

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All Issues, Step 1: Initial Factual Development

Disposition of a Portion of an Integrated Hedge

The taxpayer, with the U.S. dollar as its functional currency, borrows money denominated in a currency other than the U.S. dollar. It enters into a foreign currency hedge because it wishes to remove the foreign currency risk on the debt instrument. The taxpayer then integrates the foreign currency hedge with the debt instrument creating a qualified hedging transaction (QHT). The taxpayer disposes of a portion of the hedge in the integrated transaction prior to its maturity while keeping the remaining components of the hedge.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument. 	<ul style="list-style-type: none"> Form 1120, Line 10 (other income-for FX gains/losses) Form 1120, Line 26 (other deductions-for FX gains/losses) Form 1120, Schedule M-3, Part II, Line 15 Form 1120, Schedule M-3, Part II, Line 16 Form 1120, Schedule L, Line 18 (other current liabilities-for FX borrowing) Form 1120, Schedule L, Line 21 (other liabilities-for FX borrowing) 	

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All Issues, Step 1: Initial Factual Development (cont'd)

Disposition of a Portion of an Integrated Hedge

The taxpayer, with the U.S. dollar as its functional currency, borrows money denominated in a currency other than the U.S. dollar. It enters into a foreign currency hedge because it wishes to remove the foreign currency risk on the debt instrument. The taxpayer then integrates the foreign currency hedge with the debt instrument creating a qualified hedging transaction (QHT). The taxpayer disposes of a portion of the hedge in the integrated transaction prior to its maturity while keeping the remaining components of the hedge.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument (continued). 	<ul style="list-style-type: none"> Form 1120, Schedule L: Balance Sheet comparison of year to year change in borrowing Form 8275 – Disclosure Statement Form 8886 – Reportable Transaction Disclosure Statement <p>Request and review:</p> <ul style="list-style-type: none"> Organization charts (to help identify which entity borrows money and which entity enters into hedging transactions) Charts of accounts (review accounts related to foreign currency gains and losses) Taxpayer financial statements (review notes to financial statements for debt instruments, derivative financial instruments, and hedging transactions) 	

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All Issues, Step 1: Initial Factual Development (cont'd)

Disposition of a Portion of an Integrated Hedge

The taxpayer, with the U.S. dollar as its functional currency, borrows money denominated in a currency other than the U.S. dollar. It enters into a foreign currency hedge because it wishes to remove the foreign currency risk on the debt instrument. The taxpayer then integrates the foreign currency hedge with the debt instrument creating a qualified hedging transaction (QHT). The taxpayer disposes of a portion of the hedge in the integrated transaction prior to its maturity while keeping the remaining components of the hedge.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument (continued). 	<p>Request and review (continued):</p> <ul style="list-style-type: none"> 10-K, 10-Q, and 8-K filings (debt structure, debt issuance and retirement) Minutes of Board of Directors with respect to the debt and the hedge Committee reports with respect to the debt and the hedge Risk management policies (to gain an understanding of the taxpayer's hierarchy of risk management and to request the right personnel for questions and interviews) Hedging policies (to gain an understanding of hedging transaction flows and which documents to request and examine) Hedging identification documents including hedging recordkeeping 	

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All Issues, Step 1: Initial Factual Development (cont'd)

Disposition of a Portion of an Integrated Hedge

The taxpayer, with the U.S. dollar as its functional currency, borrows money denominated in a currency other than the U.S. dollar. It enters into a foreign currency hedge because it wishes to remove the foreign currency risk on the debt instrument. The taxpayer then integrates the foreign currency hedge with the debt instrument creating a qualified hedging transaction (QHT). The taxpayer disposes of a portion of the hedge in the integrated transaction prior to its maturity while keeping the remaining components of the hedge.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument (continued). 	<p>Request and review (continued):</p> <ul style="list-style-type: none"> ▪ Loan agreements or other instrument of indebtedness (read and understand the terms of the agreements and the parties to the agreements) ▪ Hedging contract agreements (read and understand the terms of the agreements and the parties to the agreements) ▪ Accounting entries evidencing the debt ▪ Accounting entries evidencing the hedging contract ▪ Accounting entries recording the disposed hedge ▪ Bank statements detailing cash receipts associated with the identified debt ▪ Bank statements detailing cash receipts/transfers associated with the identified hedging contract and the disposed hedge 	

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Issue 1, Step 2: Review Potential Issues

Disposition of a Portion of an Integrated Hedge		
Issue 1		
Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the disposed hedge.		
Explanation of Issue	Resources	6103 Protected Resources
<p>When a hedge is integrated for tax purposes with a qualified debt instrument (QDI), the integration creates a qualified hedging transaction (QHT). If so integrated, there is no FX gain or loss recognized on the hedge or the QDI during the period that is part of the QHT.</p> <p>If a portion of the hedge in the integrated transaction is disposed of prior to maturity of the QHT, this is considered as legging out of an integrated treatment. This creates a tax recognition event for the legging out transaction. It is necessary to gather and review facts to determine if:</p> <ul style="list-style-type: none"> ▪ There is a QHT. ▪ There is the disposition of a portion of the integrated hedge. The hedge can be disposed of by making a termination payment, sale or exchange, assignment or entering into an offsetting position. 	<ul style="list-style-type: none"> ▪ IRC § 988(c)(1)(B)(i), (c)(1)(B)(iii) ▪ IRC § 988(d) ▪ T.R. § 1.988-5(a)(6)(ii) ▪ T.R. § 1.988-5T(a)(6)(ii)(C) ▪ IPS Unit – Legging into an integrated treatment is under development 	

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Issue 1, Step 3: Additional Factual Development

Disposition of a Portion of an Integrated Hedge

Issue 1

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the disposed hedge.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument. 	<p>In addition to the items requested during the initial factual development, request and review:</p> <ul style="list-style-type: none"> ▪ A walk-through presentation of the QDI, the hedge, and the integrated transaction ▪ The business reason why borrowing funds in foreign currency to affirm the foreign currency risk is properly belonging to the U.S. Entity ▪ How the hedge is effectively managing the foreign currency risk on the underlying debt ▪ Business reason and economic substance of the disposition of only a portion of the integrated hedge 	

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Issue 1, Step 3: Additional Factual Development (cont'd)

Disposition of a Portion of an Integrated Hedge

Issue 1

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the disposed hedge.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument (continued). 	<p>Request and review:</p> <ul style="list-style-type: none"> ▪ Foreign currency risk exposure on the underlying debt subsequent to the disposed hedge (for consideration to exception rules mentioned in issue 2 and 3) ▪ Whether there is any recycling and/or new hedging transaction entered into to manage the foreign currency risk on the underlying debt (if so, the FX gain or loss on the disposed hedge may be deferred. See IPS Unit – Legging into an integrated treatment that is under development) ▪ Tax calculation schedule for any FX gain or loss, and taxpayer’s position for FX gain or loss on the disposed hedge, including reconciliation of FX gain or loss from books to tax return 	

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Issue 1, Step 3: Additional Factual Development (cont'd)

Disposition of a Portion of an Integrated Hedge		
Issue 1		
Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the disposed hedge.		
Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument (continued). 	<p>Request and review:</p> <ul style="list-style-type: none"> ▪ Tax planning including multi-step transactions, internal correspondence memos regarding the QHT, tax research, and tax opinions prepared by outside advisors with respect to the QHT and the disposed hedge 	

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Issue 1, Step 4: Develop Arguments

Disposition of a Portion of an Integrated Hedge

Issue 1

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the disposed hedge.

Explanation of Approach	Resources	6103 Protected Resources
<p>If a portion of the integrated hedge is disposed of prior to maturity of the QHT, this is considered as legging out of an integrated treatment.</p> <p>This legging out triggers a tax recognition event for the disposed hedge. Any FX gain or loss on the disposed hedge from the date of the integrated treatment to the leg-out date is recognized for tax purposes on the date of the legging out transaction.</p> <p>For transactions legging out of integrated hedges on or after September 6, 2012, and on or before September 4, 2015, section Treas. Reg. 1.988-5T(a)(6)(ii) will apply. For transactions legging out of integrated hedges prior to September 6, 2012 and after September 4, 2015, section Treas. Reg. 1.988-5(a)(6)(ii) will apply.</p>	<ul style="list-style-type: none"> ▪ IRC § 988(c)(1)(B)(i), (c)(1)(B)(iii) ▪ IRC § 988(d) ▪ T.R. § 1.988-5(a)(6)(ii) ▪ T.R. § 1.988-5T(a)(6)(ii)(C) 	



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Issue 1, Step 4: Develop Arguments (cont'd)

Disposition of a Portion of an Integrated Hedge

Issue 1

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the disposed hedge.

Explanation of Approach	Resources	6103 Protected Resources
 <p>DECISION POINT: Whether to proceed with this issue is based on a determination of whether there are a QHT, AND a disposition of the integrated hedge prior to maturity.</p> <p>The rules of legging out of integrated treatment <u>do not apply</u> to this issue if there is neither a QHT nor a disposition of a portion of the integrated hedge prior to maturity.</p>	<ul style="list-style-type: none"> ▪ IPS Unit – Legging into an integrated treatment is under development 	
 <p>CONSULTATION: Technical Specialist in FC IPN and Counsel Attorneys should be consulted when attempting to determine if there are a QHT and a disposition of the integrated hedge, and if a CFC enters into the hedge on behalf of the taxpayer</p>		

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Issue 2, Step 2: Review Potential Issues

Disposition of a Portion of an Integrated Hedge

Issue 2

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the underlying debt instrument.

Explanation of Issue	Resources	6103 Protected Resources
<p>When a portion of the integrated hedge is disposed of prior to maturity of the QHT, this is considered as legging out of an integrated treatment. This legging out is for treated for tax purposes as a disposition of the underlying debt instrument which creates a tax recognition event for the underlying debt instrument. The underlying debt instrument is treated as sold for its fair market value on the date of the legging out transaction. There may be adjustments that must be made to reflect any FX gain or loss on the QDI under T.R. 1.988-2(b)(8).</p> <p>EXCEPTION: For tax purposes, FX gain or loss on the underlying debt instrument is <u>not recognized</u> if it is determine that:</p> <ul style="list-style-type: none"> ▪ The disposition of a portion of the integrated hedge yields FX gain recognition, AND ▪ Another hedging transaction is entered into 30 days prior to the date of the disposed hedge or 30 days after that date, AND ▪ The remaining component of the hedge taken together with the new hedging transaction which is referred to in the item #2 would hedge 50% or more of the remaining currency flow of the underlying debt. 	<ul style="list-style-type: none"> ▪ IRC § Sec. 988(d) ▪ IRC § Sec. 1001(a) ▪ T.R. § 1.988-2(a) ▪ T.R. § 1.988-5(a)(6)(ii) ▪ T.R. § 1.988-5T(a)(6)(ii)(C) ▪ T.R. § 1.988-5(a)(6)(ii)(E) ▪ T.R. § 1.988-5T(a)(6)(ii)(F) 	

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Issue 2, Step 3: Additional Factual Development

Disposition of a Portion of an Integrated Hedge

Issue 2

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the underlying debt instrument.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument. 	<p>In addition to the items requested during the initial factual development, request and review:</p> <ul style="list-style-type: none"> ▪ Whether the disposition of the integrated hedge causes the recognition of a tax FX gain with respect to the terminated instrument, and if so ▪ Whether any hedging transaction is entered into 30 days prior to the date of the disposed hedge or 30 days after that date; and ▪ Whether the remaining component of the hedge taken together with the new hedging transaction would hedge 50% or more of the remaining currency flow with respect to the underlying debt 	

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Issue 2, Step 3: Additional Factual Development (cont'd)

Disposition of a Portion of an Integrated Hedge

Issue 2

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the underlying debt instrument.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument (continued). 	<p>Request and review:</p> <ul style="list-style-type: none"> Tax calculation schedule of FX gain or loss on the underlying debt including reconciliation of FX gain or loss from books to tax return Source documents used to determine the fair market value of the underlying debt instrument Schedule of any adjustment made to reflect FX gain or loss on the underlying debt under Treas. Reg. 1.988-2(b)(8) Accounting entries recording FX gain or loss with respect to the underlying debt A description of the taxpayer's tax position with respect to the underlying debt Interview tax department and treasury personnel as needed 	

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Issue 2, Step 4: Develop Arguments

Disposition of a Portion of an Integrated Hedge

Issue 2

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the underlying debt instrument.

Explanation of Approach	Resources	6103 Protected Resources
<p>If a portion of the integrated hedge is disposed of prior to maturity of the QHT, this is considered as legging out of an integrated treatment. This legging out is treated for tax purposes as a disposition of the underlying debt instrument at the date of the legging out transaction.</p> <p>For tax purposes, the underlying debt instrument is treated as sold for its fair market value on the date of the legging out transaction. Any FX gain or loss on the underlying debt from the date of the integrated treatment to the leg-out date is recognized on the date of the legging out transaction.</p> <p>For transactions legging out of integrated hedges on or after September 6, 2012, and on or before September 4, 2015, section Treas. Reg. 1.988-5T(a)(6)(ii) will apply. For transactions legging out of integrated hedges prior to September 6, 2012 and after September 4, 2015, section Treas. Reg. 1.988-5(a)(6)(ii) will apply.</p>	<ul style="list-style-type: none"> ▪ IRC § 988(c)(1)(B)(i), (c)(1)(B)(iii) ▪ IRC § 988(d) ▪ T.R. § 1.988-5(a)(6)(ii) ▪ T.R. § 1.988-5T(a)(6)(ii)(C) 	



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Issue 2, Step 4: Develop Arguments (cont'd)

Disposition of a Portion of an Integrated Hedge

Issue 2

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the underlying debt instrument.

Explanation of Approach	Resources	6103 Protected Resources
 <p>DECISION POINT: If (1) a portion of the integrated hedge is disposed of prior to maturity and for tax purposes there is realized FX gain and (2) for tax purposes, the remaining component of the hedge, taken together with any hedging transaction that is entered into 30 days prior to the date of the disposed hedge or 30 days after that date, hedges 50% or more of the remaining currency flow of the underlying debt, then there is <u>no tax FX gain or loss on the underlying debt recognized on the date of the disposed hedge.</u></p>  <p>CONSULTATION: Technical Specialist in FC IPN and Counsel Attorneys should be consulted when attempting to determine if the remaining component of the hedge taken together with the new hedging transaction hedges 50% or more of the remaining currency flow of the underlying debt.</p>	<ul style="list-style-type: none"> ▪ IRC § 988(d) ▪ T.R. § 1.988-5(a)(6)(ii)(E) ▪ T.R. § 1.988-5T(a)(6)(ii)(F) 	

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Issue 3, Step 2: Review Potential Issues

Disposition of a Portion of an Integrated Hedge		
Issue 3		
Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the remaining component of the hedge, such that it is treated as sold for its fair market value.		
Explanation of Issue	Resources	6103 Protected Resources
<p>When a portion of the integrated hedge is disposed of prior to maturity of the QHT, this is considered as legging out of an integrated treatment. This legging out is treated for tax purposes as a disposition of the remaining component of the hedge which creates a recognition event for the remaining component of the hedge. The remaining component of the hedge is treated as sold for its fair market value on the date of the legging out transaction.</p> <p>EXCEPTION: For tax purposes, FX gain or loss on the remaining component of the hedge is <u>not recognized</u> if it is determine that:</p> <ul style="list-style-type: none"> ▪ The disposition of a portion of the integrated hedge yields FX gain recognition, AND ▪ Another hedging transaction is entered into 30 days prior to the date of the disposed hedge or 30 days after that date, AND ▪ The remaining component of the hedge, taken together with the new hedging transaction which is referred to in the item #2, would hedge 50% or more of the remaining currency flow of the underlying debt. 	<ul style="list-style-type: none"> ▪ IRC § 988(d) ▪ T.R. § 1.988-5(a)(6)(ii) ▪ T.R. § 1.988-5T(a)(6)(ii)(C) ▪ T.R. § 1.988-5(a)(6)(ii)(E) ▪ T.R. § 1.988-5T(a)(6)(ii)(F) 	

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Issue 3, Step 3: Additional Factual Development

Disposition of a Portion of an Integrated Hedge

Issue 3

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the remaining component of the hedge, such that it is treated as sold for its fair market value.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument. 	<p>In addition to the items requested during initial development and the issue 2 step 3 additional factual development, request and review:</p> <ul style="list-style-type: none"> Tax calculation schedule of FX gain or loss on the remaining component of the hedge including reconciliation of FX gain or loss from books to tax return Source documents used to determine the fair market value of the remaining component of the hedge on the date of the legging out 	

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Issue 3, Step 3: Additional Factual Development (cont'd)

Disposition of a Portion of an Integrated Hedge		
Issue 3		
Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the remaining component of the hedge, such that it is treated as sold for its fair market value.		
Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ The taxpayer disposes of a portion of the hedge in the integrated transaction, which consists of the hedge and the underlying debt instrument (continued). 	<p>Request and review:</p> <ul style="list-style-type: none"> ▪ Monthly statement of the hedged positions from the counterparties showing the unrealized FX gains or losses to compare with tax calculation schedule ▪ Accounting entries recording FX gain or loss with respect to the remaining component of the hedge ▪ A description of the taxpayer's position with respect to the remaining component of the hedge ▪ Interview tax department and treasury personnel as needed about this transaction 	

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Issue 3, Step 4: Develop Arguments

Disposition of a Portion of an Integrated Hedge

Issue 3

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the remaining component of the hedge, such that it is treated as sold for its fair market value.

Explanation of Approach	Resources	6103 Protected Resources
<p>If a portion of the integrated hedge is disposed of prior to the maturity of the QHT, this is considered as legging out of the integrated treatment. This legging out is treated for tax purposes as a disposition of the remaining component of the hedge.</p> <p>For tax purposes, the remaining component of the hedge is treated as sold for its fair market value on the date of the legging out transaction. Any FX gain or loss on the remaining component of the hedge from the date of the integrated treatment to the leg-out date is recognized on the date of the legging out transaction.</p> <p>For transactions legging out of integrated hedges on or after September 6, 2012, and on or before September 4, 2015, section Treas. Reg. 1.988-5T(a)(6)(ii) will apply. For transactions legging out of integrated hedges prior to September 6, 2012 and after September 4, 2015, section Treas. Reg. 1.988-5(a)(6)(ii) will apply.</p>	<ul style="list-style-type: none"> ▪ IRC § 988(c)(1)(B)(i), (c)(1)(B)(iii) ▪ IRC § 988(d) ▪ T.R. § 1.988-5(a)(6)(ii) ▪ T.R. § 1.988-5T(a)(6)(ii)(C) 	



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Issue 3, Step 4: Develop Arguments (cont'd)

Disposition of a Portion of an Integrated Hedge

Issue 3

Whether the disposition of a portion of the integrated hedge prior to its maturity would trigger a tax recognition event for the remaining component of the hedge, such that it is treated as sold for its fair market value.

Explanation of Approach	Resources	6103 Protected Resources
 <p>DECISION POINT: If (1) a portion of the integrated hedge is disposed of prior to maturity, and for tax purposes there is a realized FX gain and (2) for tax purposes, the remaining component of the hedge, taken together with any hedging transaction that is entered into 30 days prior to the date of the disposed hedge or 30 days after that date, hedges 50% or more of the remaining currency flow of the underlying debt, then there is <u>no tax FX gain or loss on the remaining component of the hedge recognized on the date of the disposed hedge.</u></p>	<ul style="list-style-type: none"> ▪ IRC § 988(d) ▪ T.R. § 1.988-5(a)(6)(ii)(E) ▪ T.R. § 1.988-5T(a)(6)(ii)(F) 	
 <p>CONSULTATION: Technical Specialist in FC IPN and Counsel Attorneys should be consulted when attempting to determine if the remaining component of the hedge taken together with the new hedging transaction hedges 50% or more of the remaining currency flow of the underlying debt.</p>		

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Training and Additional Resources

Chapter 18.2.3 Hedging Transactions

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> ▪ Section 988: General Foreign Currency Principles Part 1 & 2 ▪ INTL Foreign Currency Issues and IFRS plus Audit Techniques ▪ Building Blocks of Financial Products 	
Other Training Materials	<ul style="list-style-type: none"> ▪ IE Phase I, Module E – Lesson 1 Foreign Currency IE Phase I: Select Module E ▪ IE Phase III, Module D – Interaction of International and Financial Products Issues IE Phase III: Select Module 5.D., second lesson 	

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Training and Additional Resources (cont'd)

Chapter 18.2.3 Hedging Transactions

Type of Resource	Description(s) and/or Instructions for Accessing	References
Other Training Materials (cont.)	<ul style="list-style-type: none"> ▪ FP Phase I, Lesson 9 Foreign Currency FP Phase I hyperlink: click here, then select “Download Financial Products Phase One Participant Guide,” then proceed to Lesson 9, page 9-1. ▪ FP Phase III, Lesson 4 Foreign Currency FP Phase III hyperlink: click here, then select “Download Financial Products Phase Three Participant Guide,” then proceed to Lesson 4, page 110. 	
Bittker & Lokken: Fundamentals of International Taxation, Chapter 74	<ul style="list-style-type: none"> ▪ Sign in to Westlaw: Bittker and Lokken Chapter 74. Foreign Currency 	
BNA Tax Management Portfolio	<ul style="list-style-type: none"> ▪ Sign into Westlaw BNA Portfolio 921-2nd Tax Aspects of Foreign Currency 	
Keyes: Federal Taxation of Financial Instruments and Transactions	<ul style="list-style-type: none"> ▪ Sign in to Westlaw: Keyes Chapter 15. Foreign Currency Denominated Instruments 	

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Training and Additional Resources (cont'd)

Chapter 18.2.3 Hedging Transactions

Type of Resource	Description(s) and/or Instructions for Accessing	References
FASB 52/ASC 830 Foreign Currency Matters	<ul style="list-style-type: none"> FASB 52/ASC830 Foreign Currency Matters (you may need to go to https://asc.fasb.org, and register for a “basic view” service, which is free) 	
FASB 133/ ASC 815 Derivatives and Hedging	<ul style="list-style-type: none"> FASB 133/ASC 815 Derivatives and Hedging (you may need to go to https://asc.fasb.org, and register for a “basic view” service, which is free) 	

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Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled Foreign Corporation
FC IPN	Foreign Currency International Practice Network
FIN IPG	Financial Instrument Issue Practice Group
FMV	Fair Market Value
FX	Foreign Exchange
QDI	Qualifying Debt Instrument
QHT	Qualified Hedging Transaction

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Index of Related Issues

Issue	Associated UIL(s)	References
Debt Modifications	9470.02-01	
Integrated Treatment	9470.02-03	
Functional Currency	9470.03	
Qualified Business Unit	9470.03-01	