Internal Revenue Service

Number: **200415009**
Release Date: 4/9/04
UILC: 1221.12-02, 446.01-00, 446.21-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

Date:
July 02, 2003

LEGEND

Taxpayer =

Dear :

This responds to a letter dated July 29, 2002, and subsequent correspondence, requesting a ruling relating to the use of derivative contracts to hedge certain obligations arising from a nonqualified deferred compensation plan ("Plan"). Specifically, the letter asks the Internal Revenue Service to determine: (1) whether the derivative contracts constitute hedging transactions under section 1221(b)(2) of the Internal Revenue Code and section 1.1221-2(b) of the Treasury Regulations; and (2) whether Taxpayer's recognition of the income, deductions, gains or losses from the derivative contracts clearly reflects income pursuant to section 1.446-4(b).

FACTS

Taxpayer is the parent of an affiliated group of corporations that files a consolidated return. Taxpayer intends to offer certain employees the opportunity to participate in the Plan, which Taxpayer represents will not constitute a qualified plan under section 401. The Plan will be unfunded and the Plan's obligation to each participating employee will be an unsecured general obligation of Taxpayer.

The Plan will enable participating employees to elect to defer receipt of certain amounts of compensation. During the term of an employee's participation in the Plan, the amount of the future compensation payments will increase or decrease as if the deferred amounts were invested in specified mutual funds ("reference funds") or other investment assets. The amount of the future compensation payments also will be adjusted to reflect the deemed reinvestment of any dividends or other distributions with respect to the reference funds and investment assets. Employees will have no right to receive currently from Taxpayer any distributions in respect of a reference fund or other investment asset. The Plan will permit Taxpayer to periodically revise the list of available reference funds and other investment assets, and participating employees will be permitted to periodically change their deemed investment allocations.

Taxpayer intends to reduce its risk of price changes with respect to its obligations under the Plan that are tied to the value of the reference funds. Rather than investing the employee deferral amounts in the reference funds, Taxpayer intends to reduce its risk by entering into derivative contracts with an unrelated party ("Counterparty"). Pursuant to the terms of the derivative contracts, Taxpayer and Counterparty will exchange payments calculated by reference to an amount initially equal to the sum of the aggregate compensation that is deferred pursuant to the Plan. The sum of the aggregate deferred compensation will increase dollar-per-dollar as additional compensation amounts are deferred, and decrease as Taxpayer makes payments under the Plan to participating employees.

Pursuant to the derivative contracts, Taxpayer will make payments at least annually to Counterparty equal to LIBOR plus a spread multiplied by the Plan's aggregate deferred compensation amount. Taxpayer and Counterparty will reset the derivative contracts to market periodically, but no less frequently than annually. Upon a reset, early termination or expiration date of the derivative contracts, Counterparty will make a payment to Taxpayer equal to the excess, if any, of the published aggregate net asset values of the employees' deemed investments in the reference funds (including the value of any deemed reinvested dividends and other distributions) on that date, over the Plan's aggregate deferred compensation amount. However, if on a reset, early termination or expiration date the aggregate deferred compensation amount exceeds the published aggregate net asset values of the participating employees' deemed investments (including the value of any deemed reinvested dividends and other distributions), Taxpayer will make a payment to Counterparty in the amount of the excess. This reset to market has the effect of paying through in cash, on at least an annual basis, both the dividend-equivalent amounts due from Counterparty (because such amounts are reflected in the then-net asset value of the reference funds) and the change in value of the Plan's aggregate deferred compensation amounts since the Plan's inception or last reset date.

The pricing of the derivative contracts will be on-market at initiation, therefore, neither party will be required to make an up-front payment. On each reset date, the aggregate deferred compensation amount will be reset to equal the published aggregate net values of the employees' deemed investments in the reference funds (including the value of any deemed reinvested dividends and other distributions) on that date. If required by Counterparty, the derivative contracts may also provide for a reset of the spread over LIBOR, as reflected in Taxpayer's obligation to make LIBOR-based payments, as relevant market spreads change.

Taxpayer will identify the derivative contracts in its books and records as hedging transactions for tax purposes pursuant to section 1.1221-2(f). A description of items and aggregate risk being hedged will also be included in this identification on a substantially contemporaneous basis. Taxpayer will include in its books and records a description of the accounting method used to account for the timing of income and expenses resulting from the derivative contracts in accordance with section 1.446-4(d).

For federal income tax purposes, Taxpayer will deduct the amount paid as future compensation to a participating employee under the Plan as the employee includes this amount in income. Income, expenses, gains and losses arising from the derivative contracts will be recognized pursuant to section 1.446-4(b) as Taxpayer recognizes deductions for amounts paid as future compensation under the Plan.

LAW AND ANALYSIS

Section 1221(a)(7) excludes from the definition of capital asset any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into.

Section 1221(b)(2)(A) defines a hedging transaction as any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily to manage certain risks, including the risk of price changes with respect to ordinary obligations incurred or to be incurred. See also, section 1.1221-2(b).

Section 1.1221-2(c)(2) states that an obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce capital gain or loss. An employer's obligation to pay future compensation pursuant to a nonqualified deferred compensation plan is an ordinary obligation. Sections 162(a)(1) and 404(a)(5); section 1.162-7.

Section 1.1221-2(d)(5) states that except as otherwise determined in published guidance or private letter ruling, the purchase or sale of a debt instrument, an equity security, or an annuity contract is not a hedging transaction even if the transaction limits or reduces the taxpayer's risk with respect to ordinary property, borrowings, or ordinary obligations. Thus, as Example 2 in section 1.1221-2(d)(5)(ii) illustrates, although a taxpayer's direct investment in shares of a mutual fund may reduce a taxpayer's risk with respect to its obligation to pay future compensation, the investment is not made primarily to manage the taxpayer's risk. Accordingly, the investment in shares of a mutual fund does not qualify as a hedging transaction for purposes of section 1221. As the preamble to section 1.1221-2 indicates, the same rationale applies for certain transactions in instruments that are not themselves debt instruments but may include a debt investment. See, e.g., section 1.446-3(g)(4), 2002-1 C.B. 707, 709.

Section 1.1221-2(f) provides rules for identifying a hedging transaction and the item being hedged.

In this case, Taxpayer will enter into the derivative contracts in the normal course of its trade or business. Taxpayer represents that it will enter into the derivative contracts to reduce the risk of price fluctuations with respect to its ordinary obligations under the Plan to pay future compensation. The derivative contracts are not proscribed investments precluded from hedging transaction characterization under section 1.1221-2(d)(5). Thus, assuming the derivative contracts meet the risk management requirements of section 1221(b)(2)(A) and section 1.1221-2(b), and the identification requirements of section 1.1221-2(f), the derivative contracts will qualify as hedging transactions for purposes of section 1221(a)(7).

Section 1.446-4(a) provides that a hedging transaction as defined in section 1.1221-2(b) must be accounted for under the rules set forth in section 1.446-4.

Section 1.446-4(b) states that 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.

Section 404(a)(5) provides that compensation paid under a nonqualified plan or arrangement deferring the receipt of compensation, if otherwise deductible, is deductible in the taxable year in which an amount attributable to the contribution is includible in the gross income of an employee participating in the plan.

Taxpayer will recognize a deduction for future compensation paid pursuant to the Plan in the taxable year in which an amount attributable to the contributions is includible in the gross income of a Plan participant. Taxpayer represents that it will match the recognition of income, deductions, gains, or losses from the derivative contracts with the recognition of corresponding deductions for future compensation paid pursuant to the Plan. Thus, assuming that the derivative contracts qualify as hedging transactions as defined in section 1.1221-2(b), the matching of income, deductions, gains or losses from the derivative contracts with the deductions recognized by Taxpayer for payments made pursuant to the Plan clearly reflects income for purposes of section 1.446-4(b).

HOLDINGS

Assuming the derivative contracts meet the risk management requirements of section 1221(b)(2)(A) and section 1.1221-2(b), and the identification requirements of section 1.1221-2(f), the derivative contracts qualify as hedging transactions for purposes of section 1221(a)(7).

Assuming the derivative contracts qualify as hedging transactions as defined in section 1.1221-2(b), the matching of income, deductions, gains and losses from the derivative contracts with deductions recognized for payments made pursuant to the Plan clearly reflects income for purposes of section 1.446-4(b).

This ruling is limited solely to issues discussed herein. No opinion is expressed or implied regarding the tax treatment of the transaction in any respect not specifically set forth by the above ruling or under the provisions of any other sections of the Code or the regulations. Specifically, no opinion is expressed or implied pertaining to issues relating to section 404 of the Code, or to the amount and timing of compensation includible in an employee's income.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Elizabeth A. Handler
Chief, Branch 1
Office of Associate Chief Counsel
(Financial Institutions & Products)

Enclosures:

Copy of this letter
Section 6110 copy