The financial PRODUCTS AREA – recent US developments

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The past year has borne witness to a number of important developments in the financial products area. This article reviews four of them: credit derivatives, straddles, mark-to-market accounting and hedging.

CREDIT DERIVATIVES

Perhaps the most innovative financial product of the nineties was the credit derivative contract. Credit derivative contracts allow parties to transfer and speculate on the creditworthiness of a taxpayer. The contracts usually take the form of a credit derivative swap (CDS) using an ISDA master agreement.

Under a typical CDS:

- a protection buyer agrees to pay a protection seller[1] either;
  - (i) a periodic amount that is a fixed number (or less frequently, a variable number) of basis points applied to a notional principal amount over the term of the CDS; or
  - (ii) less frequently, an upfront premium; and
- the protection seller agrees to pay the protection buyer the difference between the par value of a reference security of the same notional principal amount and its fair market value (or in some cases, a predetermined fixed amount) if a 'reference entity' (typically, the issuer or guarantor of the reference security) is subject to a 'credit event.'

A CDS may reference a single entity or a portfolio of reference entities. In a portfolio CDS, the protection seller is exposed to the credit risk of one or more reference entities included in the portfolio to the extent of the notional principal amount of the CDS. In certain situations, a CDS may provide for physical settlement where the protection seller may require the protection buyer to deliver the 'deliverable obligation' to the protection seller in exchange for the par amount. A 'credit event' occurs when a reference entity fails to pay, defaults, files for bankruptcy or possibly restructures its debt.

The characterisation of financial instruments is often subject to considerable uncertainty for federal income tax purposes. CDSs are often thought to fall into one of the following categories:

- guarantees;
- insurance contracts;
- put options; and
- notional principal contracts.

Each of these categories has different tax consequences; some are favourable and some are adverse. For instance, if a CDS were treated as an insurance contract, the issue would be whether amounts paid by a US protection buyer

to a foreign protection seller constitute income that is subject neither to withholding nor to the insurance-premium excise tax. Similarly, as put options, gain or loss would generally be capital gain or loss, with such gain or loss deferred until the settlement of the CDS.

The IRS and Treasury continue to study the taxation of credit derivatives. IRS Notice 2004-52[2] requests information regarding the following (as well as any other information that market participants believe may be relevant):

- CDS contractual terms, both standard and negotiated, particularly with respect to credit events, subrogation rights, security interests in collateral and collateralisation requirements in general;
- CDS pricing, particularly with respect to guarantees, contingent options and insurance;
- operation of the CDS market, particularly with respect to price quotation and dissemination;
- market practice regarding hedging, the management of basis risk, and the timing of CDS transactions relative to the assumption and disposition of analogous risks; and
- the regulatory capital, GAAP and internal booking treatment of CDSs by various market participants.

On February 25, 2004, several months before the issuance of Notice 2004-52, the Treasury Department and the IRS released proposed regulations addressing timing and character issues arising on certain swap and other derivative transactions, such as equity derivatives under which the payoff at settlement is contingent on the value of a specified index.[3] The typical contract might be an equity swap in which one party pays LIBOR to a derivatives dealer in return for a payment to the counterparty if there is appreciation on the reference equity. If there is depreciation, the counterparty makes a payment to the dealer. The proposed regulations require a complex method of estimating the projected payments under the swap, which must be re-determined on an annual basis. The taxpayer must then amortise the projected payments over the life of the swap and generally treat them as loan advances to the counterparty that is expected to make the projected payments.

Unfortunately, the proposed regulations by their terms would apply to CDSs, even though the payment itself is contingent on there being a credit event. Hopefully, this will be resolved upon completion of the IRS and Treasury study of credit derivatives envisaged by Notice 2004-52.

STRADDLES

The purpose of the straddle rules is to prevent the deferral of income and the conversion of ordinary income and short-term capital gain into long-term capital gain on straddle transactions. For straddles that are not subject to the mark-to-market rules of Section 1256, those goals are achieved by deferring the recognition of losses on unidentified straddles until the offsetting position is closed.

In general, a straddle is an offsetting position in personal property. A taxpayer holds offsetting positions if there is a substantial diminution of the risk of loss from holding any position in personal property by holding one or more other positions in personal property (whether or not of the same kind). Two or more positions are presumed to be offsetting if:

- the positions are in the same personal property, even though the property may be in a substantially altered form;
- the positions are in debt instruments of a similar maturity;
- the positions are sold or marketed as offsetting positions; or
- the aggregate margin requirement for the positions is lower than the sum of the margin requirements for each position (if held separately).

In general, a loss on one or more positions is taken into account for any taxable year only to the extent that the amount of the loss exceeds the unrecognised gain (if any) on one or more positions that were offsetting positions for one or more positions from which the loss arose. A loss that may not be taken into account for a taxable year may, subject to the limitations, be used in the succeeding year.

One of the issues that existed prior to the 2004 Tax Act was the scope of the offsetting requirement. As an example, if a taxpayer held 1,000 shares and bought a put option on 600 shares, it would possibly be considered a straddle with respect to all 1,000 shares. However, what if the put option were intended to hedge only 600 shares? The 2004 Tax Act addresses this by substantially revising a provision applicable to identified straddles. A position that is not part of an identified straddle is not treated as offsetting a position that is part of an identified straddle.

As revised, if there is a loss on an identified position, the basis of each of the identified offsetting positions is increased by an amount that bears the same ratio to the loss as the unrecognised gain on such offsetting position bears to the aggregate unrecognised gain on all offsetting positions, and the loss is not taken into account. An identified straddle is a straddle:

- that is clearly identified on the taxpayer's records as an identified straddle before the close of the day on which the straddle is acquired (or earlier if prescribed by regulations);
- to the extent provided by regulations, the value of each position of which (in the hands of the taxpayer before the creation of the straddle) is not less than the basis of the position in the hands of the taxpayer when the straddle is created; and
- that is not part of a larger straddle.

The IRS is required to prescribe regulations that specify the proper methods for clearly identifying a position as an identified straddle and the positions comprising such straddle and certain other rules of application.

Unfortunately, the requirement that an identified straddle not be part of a larger straddle raises real questions on the scope of the rule, and may in fact lead to the need for a technical correction. The requirement that the IRS must issue regulations regarding the procedures for identification raises the concern that the statute may not be operative until those regulations are issued.

MARK-TO-MARKET ACCOUNTING

Under Section 475, dealers in securities must mark to market their positions in securities at the end of the year. For many years, the IRS has struggled with the task of auditing the value of positions that are required to be marked to market, and the method by which taxpayers calculate the value of their positions has been the subject of some controversy.[4] In 2003, the Tax Court held that the method of valuing derivatives positions by a major financial institution was incorrect as it did not clearly reflect income. In May 2005, the IRS issued proposed regulations regarding the valuation of positions under the mark-to-market rules of Section 475.[5]

The proposed regulations, if finalised, would provide a 'book/tax conformity safe harbour' that would allow dealers in securities and over-the-counter derivatives to mark their open positions to market for tax purposes using the same values they use for financial accounting, regulatory and other core business purposes. Among other restrictions, the proposed regulations do not (except for eligible positions that are traded on a qualified board or exchange), allow a dealer's valuation standard to permit values for positions that are 'at or near' the bid or ask value of the position. While the concept of adopting a conformity rule is sound, many uncertainties are raised by the prohibition of valuing positions at or near the bid or ask side of the market.

HEDGING

Under the hedging rules, a taxpayer is entitled to avoid application of the straddle rules with respect to its positions in the hedging transaction. In addition, gain or loss from the hedging transaction is ordinary, thereby causing losses not to be limited as they would be if they were capital losses. Hedges must meet certain identification and risk management criteria to be considered qualifying hedging transactions. Hedging treatment is generally limited to

derivative transactions; thus, positions in stock or in mutual funds may not qualify as hedges. Taxpayers must account for income, deductions, gain and losses from the hedging transaction in a manner that clearly reflects income. Consistent with the straddle rules, forcing taxpayers to match hedging income with the item being hedged prevents taxpayers from taking losses while deferring gains.

P.L.R. 200415009[6] concerns a corporate taxpayer's use of derivative contracts to hedge its obligations under a non-qualified deferred compensation plan provided to certain of its employees (the Plan).

The ruling provides that during the term of an employee's participation in the Plan, the amount of 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 will also be adjusted to reflect the deemed reinvestment of any dividends or other distributions with respect to the reference funds and investment assets.

In order 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 invest the employee deferral amounts in the reference funds directly, the taxpayer intends to enter into derivative contracts with an unrelated party which are, in essence, total return swaps on the reference funds that are reset to market at least annually. The taxpayer stated that it would identify the derivative contracts in its books and records as hedging transactions for tax purposes pursuant to Reg. §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. The taxpayer will deduct amounts paid as future compensation under the Plan (and will recognise income, expense, gains and losses arising from the derivative contracts pursuant to Reg. §1.446-4(b)) as employees include such future compensation amounts in income.

The issue under the ruling is whether the derivative contracts will constitute hedging transactions for purposes of Section 1221(a)(7). Had the hedge been shares in stock, rather than a derivative contract, the transaction would clearly have not qualified as a hedging transaction. Presumably, the counterparty to the derivative purchased shares to reduce its own exposure.

The IRS ruled that, assuming the derivative contracts meet the risk management requirement and the identification requirement, the derivative contracts will qualify as hedging transactions for purposes of Section 1221(a)(7). Further, the IRS ruled that the matching of income, deductions, gains and losses from the derivative contracts with deductions recognised for payments made pursuant to the Plan clearly reflects income for purposes of Reg. §1.446-4(b).

Notes:

1. A buyer pursuant to a CDS is said to be buying protection, and a seller is said to be selling protection.
2. 2004-32 I.R.B. 168 (August 9, 2004).
3. REG-166012-02, 2004-13 I.R.B. 655 (Feb. 26, 2004).
4. See Bank One Corp. v. Commissioner, 120 T.C. 174 (2003).
5. REG-100420-03 (May 24, 2005).
6. July 2, 2003.

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