

United States

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General Tax Accounting Rules, IFRS and Derivatives

1. Introduction

1.1. Reluctance on future adoption of IFRS for tax purposes

For US companies, the starting point for taxable income is based on the method of accounting by which the taxpayer regularly computes income in keeping its books (e.g. the accrual method, which is typically required also for US GAAP). In the United States, the Securities and Exchange Commission has proposed a roadmap for the adoption for IFRS by US issuers, beginning in 2014. The Internal Revenue Service is in the process of studying IFRS, but any move toward IFRS or another starting point for tax will require careful consideration of the implications of a company's accounting policy choices on required tax accounting method changes, cash taxes and tax compliance.

Although the tax starting point for most US companies is currently US GAAP, there are certain elections within the US Tax Code that will be impacted by implementation of IFRS. For example companies which are dealers in securities under Internal Revenue Code (IRC) Sec. 475 are required to report inventory (e.g. securities, derivatives) at fair market value rather than lower of cost or market. As such, gains or losses on inventory must be reported as if all securities were sold for their "fair market value" on the last business day of each tax year. Under an election that is available to taxpayers, the definition of fair value under Accounting Standards Codification (ASC) 820 *Fair Value Measurements and Disclosures*¹ has generally been used for tax purposes. However, fair value, as defined by International Accounting Standard (IAS) 39, *Financial Instruments: Recognition and Measurement*, may not be an appropriate measurement basis if differences in fair value measurement exist between US GAAP and IFRS.

1.2. Effect of changing from US GAAP to IFRS

While there is no provision specifically forcing companies to start with US GAAP in determining taxable income, as a practical matter, the starting point for taxable income is based on the current US GAAP method of accounting. In general, the following three requirements are applicable to tax methods of accounting: (1) the method must conform to the taxpayer's method of computing income in keeping its books, (2) the method must clearly reflect the income of the taxpayer and (3) except with permission of the Commissioner (or as otherwise provided by the IRC, Treasury regulations, or published Revenue Rulings or Revenue Procedures), a taxpayer must use its method of account-

ing consistently and without change. A conversion from US GAAP to IFRS would require companies to reassess their existing accounting methods used for financial reporting purposes and analyse the potential impacts on their US tax accounting methods and tax planning strategies. Companies should then consider whether they should continue to follow the US GAAP method for tax or change to the new IFRS accounting method if that method is a permissible method for US tax purposes.

2. Recognition Issues

As mentioned above, IFRS rules will not apply to US companies. For financial reporting purposes, under US GAAP the statement of financial condition should reflect all regular-way trades on an accrual or trade-date basis, as all of the risks, benefits and economic potential are created and conveyed as of that date. Similarly, for tax purposes, Revenue Ruling 74-372 holds that a stock brokerage business using the accrual method of accounting must accrue the commission income on the sale or purchase of securities for a customer on the trade date rather than the settlement date since all events that fix the taxpayer's right to receive the commission have occurred on the trade date.

This differs from the recognition rules for financial assets and liabilities under IFRS in that, although recognition is based on when the entity becomes party to the contractual provisions of the instrument, there is a choice as to whether trade date or settlement date accounting is used. Notwithstanding when an asset is recognized for balance sheet purposes (trade or settlement date), both IFRS and US GAAP require that income be accounted for from trade date in the same way it will account for the asset when it is eventually recognized. For example under IFRS, unrealized gains and losses are accrued between trade date and settlement date for assets that will be accounted for as "Trading" when settled even when the entity has chosen settlement date accounting for balance sheet purposes.

For US tax purposes, an accrual basis taxpayer includes items in income in the year in which all events have

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1. Formerly Statement of Financial Accounting Standard No. 157, *Fair Value Measurements*.

occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy. Although this is similar to the US GAAP approach, it is not dependent upon the rules for financial accounting and courts interpret the tax standards independently of the financial reporting standards.²

2.1. Derecognition issues

For financial reporting purposes, US GAAP evaluates the derecognition of financial assets via a control-based model rather than a risks and rewards model. As such, derecognition of financial assets occurs when effective control has been surrendered over the financial asset.

For tax purposes, recognition of an asset is based on a risks and rewards of ownership analysis. Thus, tax and US GAAP depart from one another in this area.

2.2. Conclusion

So far, IFRS have not yet been adopted in the United States for either financial or tax reporting. Tax accounting for derivatives may occur on the basis of fair value measurement. The question is whether the rules as laid down in IAS 39 are useful and acceptable for US tax purposes. As regards recognition and derecognition of financial assets, US tax reporting is based on concepts that differ from both IFRS and US GAAP.

3. Hybrid Instruments and Embedded Derivatives

US tax analysis applies a substance-over-form standard. As a result, to determine the tax consequences of a transaction or series of transactions, the substance of a transaction, rather than its form, is analysed. Thus, if a financial instrument is denominated as a debt instrument, it might be regarded as equity for tax purposes, if for instance the instrument had an unusually long term, or were payable purely out of profits. Similarly, if the owner of an instrument sells the instrument, and then agrees to repurchase it for a pre-agreed amount, the two transactions may be aggregated and treated in substance as a financing transaction.³

Financial transactions, while governed by the substance doctrine, are rarely bifurcated for federal income tax purposes.⁴ The rule is the same for derivative transactions. However, in the case of certain notional principal contracts, it is sometimes necessary to bifurcate an instrument. Thus, if an interest rate swap calls for a prepayment of one of the legs, the transaction may be recast as a an interest rate swap and a loan.⁵ However, the treatment of hybrid instruments is under current analysis by the IRS and the US Treasury.⁶

4. Netting and Matching

Neither US GAAP nor US tax accounting embraces fully adoption of the netting principle, but each uses a modified approach or applies the concept in particular circumstances. Under US GAAP, ASC 210-20, Offsetting, and in particular ASC 210-20-05 establish the general

position that netting is inappropriate except where a right to set off exists. ASC 210-20-45-1 specifies four tests that must be met before assets and liabilities may be netted: (1) each party must owe the other specific amounts, (2) the reporting party has the right to set off the amount receivable from the other party, (3) the reporting party intends to set off and (4) the right of setoff is enforceable by law.

For US tax purposes, generally, liabilities and assets are not netted. However, in particular circumstances, a similar effect may result. In the case of tax-exempt bonds, US Treasury regulations allow a bond and a fixed-to-variable-rate hedge to be integrated and treated as a single instrument if certain conditions are met.⁷ Similarly, the Internal Revenue Code contemplates that a currency hedge that is part of a larger transaction may be integrated into the larger transaction and treated as a single transaction.⁸

Under US GAAP, the matching principle is an extension of the revenue recognition convention. Under the matching principle, expenses relating to an item of revenue must be recorded in the same period as the item of revenue. This means that when an expense is incurred related to future revenue, it may be booked as a deferred asset. In the case of inventory, the expense would appear as the cost of goods sold.

US tax accounting approaches the recognition of expenses differently than US GAAP does, and does not start with a general requirement that expenses should be matched to revenues. However, in a variety of circumstances a similar result will be obtained. In some contexts, costs related to the future production of income are capitalized or suspended until the income is recognized. For example IRC Sec. 263A creates a general rule that the costs related to the production of inventory must be capitalized and included in the inventory cost.

IRC Sec. 1092 provides that any loss with respect to one or more positions shall be taken into account for any taxable year only to the extent that the amount of such loss exceeds the unrecognized gain (if any) with respect to one or more positions that were offsetting positions with respect to one or more positions from which the loss arose.⁹ A taxpayer holds offsetting positions with respect

2. *Thor Power Tool Co. v. Commissioner*, 439 US 522 (1979) (in view of the Treasury's markedly different goals and responsibilities, there is no presumptive equivalency between tax and financial accounting).

3. *Nebraska Dept of Revenue v. Loewenstein*, 523 U.S. 123 (1994) (addressing ownership of a security for state tax purposes).

4. See, e.g., *Chock Full O' Nuts v. United States*, 453 F.2d 300 (2d Cir. 1971) (a convertible debenture issued as a convertible debenture is an indivisible unit and is not taxed like a bond/warrant investment unit that represents two separate and independent obligations); *Hunt Foods and Industries, Inc. v. Comm'r*, 57 T.C. 633 (1972) (Same); P.L.R. 9824026 (Mar. 12, 1998) (Treas. Reg. § 1.446-3 treats a notional principal contract as a single indivisible financial instrument rather than a series of forward contracts even though that would be the economic equivalent).

5. Treas. Reg. Sec. 1.446-3(f)(2)(iii)(B).

6. IRS Notice 2008-2, 2008-2 I.R.B. 252 (possible guidance on prepaid forward contracts being considered).

7. Treas. Reg. Sec. 1.1275-6.

8. IRC Sec. 988(d).

9. Any loss that may not be taken into account under the rule stated above is treated as sustained in the succeeding taxable year. IRC Sec. 1092(a)(1)(B).

to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding one or more other positions with respect to personal property (whether or not of the same kind).¹⁰

Two or more positions will be presumed to be offsetting if (1) the positions are in the same personal property (whether established in such property or a contract for such property), (2) the positions are in the same personal property, even though such property may be in a substantially altered form, (3) the positions are in debt instruments of a similar maturity or other debt instruments described in regulations, (4) the positions are sold or marketed as offsetting positions (whether or not such positions are called a straddle, spread, butterfly or any similar name), (5) the aggregate margin requirement for such positions is lower than the sum of the margin requirements for each such position or (6) there are other factors or tests determined by regulations that establish that the positions are offsetting. Except as to positions that are marketed as offsetting or in respect of which the margin requirement for the aggregate position is lower than the sum of the margin requirements for the separate positions, two or more positions are presumed to be offsetting positions only if the value of one or more of such positions ordinarily varies inversely with the value of one or more other such positions.¹¹

Personal property, for these purposes, means any personal property of a type that is actively traded.¹² With respect to a debt instrument, property is actively traded if a debt market exists with respect to the instrument.¹³ A debt market exists with respect to a debt instrument if price quotations for the instrument are readily available from brokers, dealers or traders. A debt market does not exist with respect to a debt instrument if (1) no other outstanding debt instrument of the issuer is traded on an established financial market, (2) the original stated principal amount of the issue that includes the debt instrument does not exceed USD 25 million, (3) the conditions and covenants relating to the issuer's performance with respect to the debt instrument are materially less restrictive than the conditions and covenants included in all of the issuer's other traded debt, or (4) the maturity date of the debt instrument is more than three years after the latest maturity date of the issuer's other traded debt.¹⁴

The rule described above regarding the suspension of losses related to offsetting positions does not apply with respect to identified positions comprising an identified straddle.¹⁵ In general, a straddle means offsetting positions with respect to personal property.¹⁶ A straddle is an identified straddle if it is clearly identified on the taxpayer's records as an identified straddle before the close of the day on which the straddle is acquired.¹⁷ If there is a loss with respect to an identified straddle, the basis of each of the identified offsetting positions in the identified straddle will be increased by an amount that bears the same ratio to the loss as the unrecognized gain with respect to such offsetting position bears to the aggregate unrecognized gain with respect to all such offsetting

positions and such loss will not otherwise be taken into account.

In addition to the limitations on the recognition of losses in respect of straddles provided by IRC Sec. 1092, IRC Sec. 263(g) provides that no deduction is allowed for interest and carrying charges allocable to personal property that is part of a straddle as defined in IRC Sec. 1092(c). Any amount not allowed as a deduction by reason of the preceding sentence will be chargeable to the capital account with respect to personal property to which such amount relates.¹⁸ For these purposes, interest and carrying charges means the excess of (1) the sum of interest incurred to purchase or carry the personal property and all other costs incurred to carry the personal property over (2) amounts included in gross income as interest, original issue discount, market discount, discount on certain short-term obligations or dividend income with respect to the property.

IRC Sec. 263(g) does not apply to securities to which IRC Sec. 475 applies¹⁹ or to any hedging transactions, as defined in IRC Sec. 1256(e).²⁰

5. Valuation Issues

5.1. Valuation

The valuation of an asset is based on its fair market value. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.²¹ Where the taxpayer is a dealer in securities or commodities, under IRC Sec. 475, the taxpayer is allowed to use the valuation methodology used for financial statement purposes, provided an election is made by the taxpayer.²² Thus, implementation of IFRS will require a reassessment of value. The IRS has not made a determination as to whether the method of valuation is considered an accounting method change, but there are strong arguments against such approach.

10. IRC Sec. 1092(c)(2)(A). A position that is not part of an identified straddle will not be treated as an offsetting position with respect to a position that is part of an identified straddle. IRC Sec. 1092(c)(2)(B).

11. IRC Sec. 1092(c)(3).

12. IRC Sec. 1092(d)(1).

13. IRC Sec. 1092(b)(1)(vii).

14. Treas. Reg. Sec. 1.1092(d)-1(b)(2)(ii).

15. IRC Sec. 1092(a)(2)(A)(i).

16. IRC Sec. 1092(c)(1).

17. Identification may also be made at such other time as provided by regulations. IRC Sec. 1092(a)(2)(B).

18. IRC Sec. 263(g)(1).

19. IRC Sec. 475(d)(1). Dealers in securities are required to carry any securities included in inventory at their fair market value. IRC Sec. 475(a)(1).

20. IRC Sec. 1263(g)(3). Sec. 1256(e)(2) provides that for the purposes of Sec. 1256(e) "hedging transaction" has the meaning provided in Sec. 1221(b)(2)(A) if, before the close of the day on which such transaction was entered into, the taxpayer clearly identifies such transaction as being a hedging transaction. Hedging transactions are discussed in greater detail below.

21. Treas. Reg. Sec. 20.2031(b).

22. Treas. Reg. Sec. 1.475-4(a)(1).

5.2. Amortized cost method

The amortized cost method is not used for tax purposes. Rather, financial instruments are held at their purchase price until disposed of, or on a mark-to-market basis if the owner is a dealer or trader in securities that elects mark-to-market treatment under IRC Sec. 475.

5.3. Held to maturity

The US GAAP principle that an asset may be held to maturity does not apply for federal income tax purposes. Instead, the distinctions are between assets held as investments or assets held by either a dealer or an electing mark-to-market trader under IRC Sec. 475. Under IRC Sec. 475(b)(1), when a taxpayer that is subject to mark-to-market taxation wishes to keep an asset out of mark-to-market taxation, it may designate the asset as (1) held for investment, (2) not held for sale or (3) a hedge with respect to a position that is not marked to market or with respect to a position, right to income, or a liability that is not a security in the hands of the taxpayer.

5.4. Impairment

During times of impairment, there are two questions that need to be addressed: (1) is it possible to write down the asset in question and (2) is it possible to write down the asset in question?

Prior to actual disposition of a debt instrument, the taxpayer may take a loss under either IRC Sec. 165 or 166. IRC Sec. 165 is applicable to securities that are treated as capital assets that become wholly worthless during the year. Under IRC Sec. 166, a taxpayer may be able to deduct losses with respect to debt that has become wholly or partially worthless if either (1) the lender is a corporation or (2) the debt is not a security within the meaning of IRC Sec. 165(g)(2)(C). The deduction under IRC Sec. 166 is generally ordinary. However, the deduction permitted under IRC Sec. 166 is not available in the case of non-business debts held by non-corporate taxpayers. For non-business debts that become worthless, a short-term capital loss is allowed.

With respect to interest, an accrual method taxpayer must include interest on the obligation unless there is doubtful collectability with respect to the payment.²³ Mere default does not preclude inclusion of an expected payment. There may be no reasonable expectation of repayment. The issue is less certain with respect to original issue discount, since the requirement that interest be included is statutory and, read literally, this requires inclusion even if there is no expectation of repayment.²⁴ Informally, IRS officials have stated that the IRS is revisiting this position, but whether there is a change remains uncertain.

6. Hedge Accounting

For US GAAP, ASC 815 *Derivatives and Hedging*²⁵ permits hedge accounting if certain conditions are met. For a derivative designated as hedging the exposure to changes in the fair market value of a recognized asset or

liability or a firm commitment, the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction, the effective portion of a derivative's gain or loss is initially reported as a component of other comprehensive income and subsequently reclassified into earnings when the forecasted transaction affects earnings. For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income as part of the cumulative translation adjustment.

Under the US Treasury regulations, a hedging transaction defined in Treas. Reg. Sec. 1.1221-2(b) must be accounted for under the rules of Treas. Reg. Sec. 1.446-4.²⁶ This requirement applies regardless of whether the character of the gain or loss on the hedging transaction is determined under Treas. Reg. Sec. 1.1221-2.

The regulations require taxpayers to clearly reflect income by reasonably matching the timing of the income, deduction, gain or loss from a hedging transaction with the timing of income, deduction, gain or loss from the hedged item or items.²⁷ 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. For any given type of hedging transaction, there may be more than one method of accounting that satisfies the clear reflection requirement. The regulations generally provide significant flexibility to taxpayers in determining the appropriate method of accounting for their different hedging transactions. The regulations do not specifically state that taxpayers may use the same method used for financial accounting purposes, but the preamble to the regulations indicates that the Internal Revenue Service and the Treasury expect that the hedge accounting methods employed by most taxpayers for financial accounting purposes will satisfy the clear reflection standard in the final regulations.

The regulations indicate that the following method may be appropriate for taking into account income, deduc-

23. *Corn Exchange Bank v. U.S.*, 37 F.2d 34 (2d Cir. 1930) ("[A] taxpayer, even though keeping his books upon an accrual basis, should not be required to pay a tax on an accrued income unless it is good and collectable, and, where it is of doubtful collectability or it is reasonably certain it will not be collected, it would be an injustice to the taxpayer to insist upon taxation.")

24. TAM 9538007 (13 June 1995) (OID must be accrued despite reasonable expectation of repayment).

25. Formerly, Statement of Financial Accounting Standards 133, *Derivatives and Hedging Activities*.

26. Certain taxpayers may qualify for an exception. Certain types of hedges are also excluded, namely: hedges subject to the mark-to-market rules of IRC Sec. 475; a hedge of a bond that is treated as an integrated transaction with the bond under Treas. Reg. Sec. 1.1275-6; and a currency hedge, if it is treated as an integrated transaction under Treas. Reg. Sec. 1.988-5.

27. Treas. Reg. Sec. 1.446-4(b).

tion, gain or loss from hedges of aggregate risk.²⁸ The method described would provide for the hedging transactions to be marked to market at regular intervals for which the taxpayer has the necessary data, but no less frequently than quarterly; and the income, deduction, gain or loss attributable to the realization or periodic marking to market of hedging transactions is taken into account over the period for which the hedging transactions are intended to reduce risk. Although the period over which the hedging transactions are intended to reduce risk may change, the period must be reasonable and consistent with the taxpayer's hedging policies and strategies.

In the case of a transaction that hedges an item that is marked to market under the taxpayer's method of accounting, marking the hedge to market clearly reflects income.²⁹

If a hedging transaction hedges purchases of inventory, the gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory. Similarly, if a hedging transaction hedges sales of inventory, gain or loss on the hedging transaction may be taken into account in the same period in which it would be taken into account if the gain or loss were treated as an element of sales proceeds.³⁰

The gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held 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 an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, for example generally is accounted for using constant yield principles.³¹

A hedge is defined under Treas. Reg. Sec. 1.1221-2(b) and (c)(3) to include any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily (among other things) to manage risk of (1) price changes or currency fluctuations with respect to ordinary property, (2) 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 or (3) an aggregate risk of interest rate changes, prices changes and/or currency fluctuations if all but a *de minimis* amount of the risk is

with respect to ordinary property, ordinary obligations or borrowings.

For the purposes of IRC Sec. 1221(b)(2)(A), property is ordinary property only if a sale or exchange of the property could not produce capital gain or loss under any circumstances.³²

As mentioned above, dealers in securities are required to carry any securities included in inventory at their fair market value.³³ In addition, for the purposes of IRC Sec. 475, a security includes a position that (1) is not otherwise a security, (2) is a hedge with respect to a position that is a security and (3) is clearly identified in the dealer's records as being described in IRC Sec. 475(c)(2)(F) before the close of the day on which the position is acquired. For these purposes, "hedge" means any position that manages the dealer's risk of interest rate or price changes or currency fluctuations, including any position that is reasonably expected to become a hedge within 60 days after the acquisition of the position.³⁴

Because a hedge against a security is also a security for the purposes of the mark-to-market rules, the fluctuations in the values of both sides of the position will be recognized for dealers in securities.

7. Countries Not Following IFRS

The United States is in transition to uniformity with IFRS for financial accounting purposes, but there has been little discussion about adopting IFRS for tax accounting purposes. As mentioned above, derivatives are treated in a variety of contexts with special rules. The rules may be more or less workable in particular situations depending upon the facts and the taxpayer's desired goals. For example some taxpayers may struggle to avoid the mark-to-market rules, while other taxpayers may struggle to become subject to them. Widely varying views may result as to the workability of the rules depending upon the tax advisor's level of confidence that the taxpayer's goals may be obtained.

28. Treas. Reg. Sec. 1.446-4(e)(1)(ii).

29. Treas. Reg. Sec. 1.446-4(e)(2).

30. Treas. Reg. Sec. 1.446-4(e)(3).

31. Treas. Reg. Sec. 1.446-4(e)(4).

32. Treas. Reg. Sec. 1.1221-2(c)(2).

33. IRC Sec. 475(a)(1).

34. IRC Sec. 475(c)(3).