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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9736]

RIN 1545-BK98

Integrated Hedging Transactions of Qualifying Debt

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations

SUMMARY: This document contains final regulations that address certain integrated transactions that involve a foreign currency denominated debt instrument and multiple associated hedging transactions. The regulations provide that if a taxpayer has identified multiple hedges as being part of a qualified hedging transaction, and the taxpayer has terminated at least one but less than all of the hedges (including a portion of one or more of the hedges), the taxpayer must treat the remaining hedges as having been sold for fair market value on the date of disposition of the terminated hedge.

DATES: Effective Date. These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Date. These regulations apply to leg-outs within the meaning of §1.988-5(a)(6)(ii) that occur on or after September 6, 2012.

FOR FURTHER INFORMATION CONTACT: Sheila Ramaswamy, at (202) 317-6938 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 5, 2012, the Treasury Department and the IRS issued temporary regulations (TD 9598) (the “Temporary Regulations”) that revised the legging out rules of §1.988-5(a)(6)(ii) applicable to hedging transactions under section 988(d). No public hearing was requested or held. One comment was received, which is available at www.regulations.gov or upon request. After consideration of the comment, the Temporary Regulations are adopted as final regulations without substantive change. The Temporary Regulations are removed.

Summary of Comments and Explanation of Revisions

The only comment received on the Temporary Regulations suggested that the promulgation of the Temporary Regulations was unnecessary because the prior regulations did not support the taxpayer reporting position that the Temporary Regulations were designed to prevent. The comment considered the taxpayer position addressed in the Temporary Regulations to be inconsistent with both the purposes of section 988(d) and the economic substance of the transaction. Although the comment finds the Temporary Regulations ultimately unnecessary, it acknowledges that the section 988 hedging rules are a complicated area of law and that the prior regulations could be improved to provide greater certainty to taxpayers. The Treasury Department and the IRS have determined that the Temporary Regulations are useful in clarifying the section 988(d) integration rules — as well as in preventing unintended approaches to legging out under those rules — and thus should be adopted as final.

The comment recommended that the Treasury Department and the IRS consider aligning the hedge integration regime under section 988 with the approach taken in regulations under section 1275 on the basis that the section 1275 approach is more consistent with economic reality. The §1.1275-6 regulations generally allow the integration of a qualifying debt instrument with a hedge or combination of hedges if the

combined cash flows of the components are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. However, a financial instrument that hedges currency risk cannot be integrated as a §1.1275-6 hedge. See §1.1275-6(b)(2). Under the legging out rules of §1.1275-6, a taxpayer that legs out of an integrated transaction is treated as terminating the synthetic debt instrument for its fair market value and recognizing any gain or loss. If the taxpayer remains liable on the qualifying debt instrument after the leg-out, adjustments are made to reflect any difference between the fair market value of the qualifying debt instrument and its adjusted issue price. If the taxpayer remains a party to the §1.1275-6 hedge, the hedge is treated as entered into at its fair market value. By contrast, subject to §1.988-5T(a)(6)(ii)(F), the legging out rules under §1.988-5 treat a taxpayer that legs out of a synthetic debt instrument under section 988 as having disposed of any remaining hedges, and those hedges cannot be part of a qualified hedging transaction for any period after the leg-out date.

The Treasury Department and the IRS have determined that achieving greater alignment between the hedge integration regimes under sections 988 and 1275 is beyond the scope of this project and unnecessary to achieve the purpose of the Temporary Regulations. The limited purpose of the Temporary Regulations was to clarify the application of the legging out rules under §1.988-5 to a particular fact pattern rather than to undertake a more general revision of those rules. When some of the hedge components of a qualified hedging transaction are disposed of on a leg-out date, deeming a disposition of all remaining components is sufficient to achieve a clear reflection of income. Continuing to treat the remaining components as integrated, as under the rule of §1.1275-6, would represent a departure from the approach taken in the original §1.988-5 regulations. Nonetheless, the Treasury Department and the IRS will

continue to consider whether the hedge integration regimes under sections 988 and 1275 should be modified and brought into closer conformity.

As further support for the recommendation to achieve better alignment between §§1.988-5 and 1.1275-6, the comment also suggested that the provision in §1.988-5T(a)(6)(ii)(F) of the Temporary Regulations, which was also included in the prior final regulations, would be unnecessary if the regulations were modified to conform to §1.1275-6. Under §1.988-5T(a)(6)(ii)(F), if a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the debt instrument or hedge that is disposed of or otherwise terminated, then the taxpayer is not treated as legging out if during the period beginning 30 days before the leg-out date and ending 30 days after that date the taxpayer enters into another transaction that, taken together with any remaining components of the hedge, hedges at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction. Section 1.988-5T(a)(6)(ii)(F) also provides a similar rule where a taxpayer has a qualified hedging transaction comprised of multiple components. In such a case, the taxpayer will not be treated as legging out of the qualified hedging transaction if the taxpayer terminates all or a part of one or more of the components and realizes a net gain with respect to the terminated component, components, or portions thereof, provided that the remaining components of the hedge by themselves hedge at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction.

The comment suggests that this provision of the section 988 hedging rules is unnecessarily complex, as well as incomplete because it does not cover situations in which, upon legging out, a taxpayer recognizes a loss on the debt instrument or hedge that is disposed of or otherwise terminated. However, as stated in this preamble, in

issuing the Temporary Regulations, the Treasury Department and the IRS only sought to clarify the application of the section 988 hedging rules to a particular fact pattern and did not seek to undertake a more general revision of those rules. Accordingly, the Treasury Department and the IRS have determined that modifications to §1.988-5T(a)(6)(ii)(F) are beyond the scope of this guidance project. However, the Treasury Department and the IRS will continue to consider whether any modifications to the rule are necessary or appropriate.

Finally, the comment also recommended that, even if the final regulations do not adopt the recommendation to align with the approach taken in §1.1275-6, the Temporary Regulations should be modified to provide that, when an issuer of a qualifying debt instrument legs out but continues to be the obligor on the qualifying debt instrument, the issuer should be deemed to repurchase and reissue the debt instrument for its then fair market value. The Temporary Regulations instead provide that, in such a case, the debt instrument is “treated as sold for its fair market value.” The comment notes that the sale of a debt instrument has no tax consequences for the issuer of the instrument. The Treasury Department and the IRS agree that this aspect of the Temporary Regulations should be modified and, for the sake of consistency, these final regulations adopt the phrasing “treated as sold or otherwise terminated by the taxpayer for its fair market value,” which is used in §1.988-5(a)(6)(i)(C) (regarding legging in).

The final regulations also update the dates in two existing examples, to be consistent with the applicability date of the revised legging out rules. Additionally, the final regulations reflect minor wording changes to the Temporary Regulations for purposes of improving clarity. The Treasury Department and the IRS do not intend these changes to be interpreted as substantive changes to the Temporary Regulations.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations will not have a significant impact on a substantial number of small entities. This certification is based upon the fact that these regulations merely clarify an existing standard and do not impose a collection of information on small entities. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Sheila Ramaswamy, Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoptions of Amendment to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.988-5 is amended by:

1. Revising paragraph (a)(6)(ii).
2. Adding Example 11 to paragraph (a)(9)(iv).
3. Revising paragraph (a)(10)(iv).

The revisions and addition read as follows:

§1.988-5 Section 988(d) hedging transactions.

(a) * * *

(6) * * *

(ii) Legging out. With respect to a qualifying debt instrument and hedge that are properly identified as a qualified hedging transaction, “legging out” of integrated treatment under this paragraph (a) means that the taxpayer disposes of or otherwise terminates all or any portion of the qualifying debt instrument or the hedge before maturity of the qualified hedging transaction. For purposes of the preceding sentence, if the taxpayer changes a material term of the qualifying debt instrument (for example, exercises an option to change the interest rate or index, or the maturity date) or the hedge (for example, changes the interest or exchange rates underlying the hedge, or the expiration date) before maturity of the qualified hedging transaction, the taxpayer will be deemed to have disposed of or otherwise terminated all or any portion of the qualifying debt instrument or the hedge, as applicable. A taxpayer that disposes of or terminates a qualified hedging transaction (that is, disposes of or terminates both the qualifying debt instrument and the hedge in their entirety on the same day) is considered to have disposed of or otherwise terminated the synthetic debt instrument rather than legging out. See paragraph (a)(9)(iv) of this section, Example 10 for an illustration of this rule. If a taxpayer legs out of integrated treatment, the following rules apply:

(A) The transaction will be treated as a qualified hedging transaction during the

time the requirements of this paragraph (a) were satisfied.

(B) If all of the instruments comprising the hedge (each such instrument, a component) are disposed of or otherwise terminated, the qualifying debt instrument is treated as sold or otherwise terminated by the taxpayer for its fair market value on the date the hedge is disposed of or otherwise terminated (the leg-out date), and any gain or loss (including gain or loss resulting from factors other than movements in exchange rates) from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date is used to determine exchange gain or loss on the debt instrument for the period beginning on the leg-out date and ending on the date such instrument matures or is disposed of or otherwise terminated. Proper adjustment must be made to reflect any gain or loss taken into account. The netting rule of §1.988-2(b)(8) applies. See paragraph (a)(9)(iv) of this section, Example 4 and Example 5 for an illustration of this rule.

(C) If a hedge has more than one component (and such components have been properly identified as being part of the qualified hedging transaction) and at least one but not all of the components that comprise the hedge has been disposed of or otherwise terminated, or if part of any component of the hedge has been terminated (whether a hedge consists of a single or multiple components), the date such component (or part thereof) is disposed of or terminated is considered the leg-out date and the qualifying debt instrument is treated as sold or otherwise terminated by the taxpayer for its fair market value in accordance with the rules of paragraph (a)(6)(ii)(B) of this section on such leg-out date. In addition, all of the remaining components (or parts thereof) that have not been disposed of or otherwise terminated are treated as sold by the taxpayer for their fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out

date. To the extent relevant, the spot rate on the leg-out date is used to determine exchange gain or loss on the remaining components (or parts thereof) for the period beginning on the leg-out date and ending on the date such components (or parts thereof) are disposed of or otherwise terminated. See paragraph (a)(9)(iv) of this section, Example 11 for an illustration of this rule.

(D) If the qualifying debt instrument is disposed of or otherwise terminated in whole or in part, the date of such disposition or termination is considered the leg-out date. Accordingly, the hedge (including all components making up the hedge in their entirety) that is part of the qualified hedging transaction is treated as sold by the taxpayer for its fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. To the extent relevant, the spot rate on the leg-out date is used to determine exchange gain or loss on the hedge (including all components thereof) for the period beginning on the leg-out date and ending on the date such hedge is disposed of or otherwise terminated.

(E) Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the part of the qualified hedging transaction that has not been disposed of or otherwise terminated (that is, the remaining debt instrument in its entirety even if partially hedged, or the remaining components of the hedge) cannot be part of a qualified hedging transaction for any period after the leg-out date.

(F) If a taxpayer legs out of a qualified hedging transaction and realizes a net gain with respect to the debt instrument that is disposed of or otherwise terminated, then paragraph (a)(6)(ii)(B), (C), and (D) of this section, as appropriate, will not apply if during the period beginning 30 days before the leg-out date and ending 30 days after that date the taxpayer enters into another transaction that, taken together with any remaining components of the hedge, hedges at least 50 percent of the remaining

currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction or, if appropriate, an equivalent amount under the hedge (or any remaining components thereof) that was part of the qualified hedging transaction.

Similarly, in a case in which a hedge has multiple components that are part of a qualified hedging transaction, if the taxpayer legs out of a qualified hedging transaction by terminating one such component or a part of one or more such components and realizes a net gain with respect to the terminated component, components, or portions thereof, then paragraphs (a)(6)(ii)(B), (C), and (D) of this section, as appropriate, will not apply if the remaining components of the hedge (including parts thereof) by themselves hedge at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction. See paragraph (a)(9)(iv) of this section, Example 11 for an illustration of this rule.

* * * * *

(9) * * *

(iv) * * *

Example 11. (i) K is a domestic corporation with the U.S. dollar as its functional currency. On January 1, 2013, K borrows 100 British pounds (£) for two years at a 10% rate of interest payable on December 31 of each year with no principal payment due until maturity on December 31, 2014. Assume that the spot rate on January 1, 2013, is £1=\$1. On the same date, K enters into two swap contracts with an unrelated counterparty that economically results in the transformation of the fixed rate £100 borrowing to a floating rate dollar borrowing. The terms of the swaps are as follows:

(A) Swap #1, Currency swap. On January 1, 2013, K will exchange £100 for \$100.

(1) On December 31 of both 2013 and 2014, K will exchange \$8 for £10;

(2) On December 31, 2014, K will exchange \$100 for £100.

(B) Swap #2, Interest rate swap. On December 31 of both 2013 and 2014, K will pay LIBOR times a notional principal amount of \$100 and will receive 8% times the same \$100 notional principal amount.

(ii) Assume that K properly identifies the pound borrowing and the swap contracts as a qualified hedging transaction as provided in paragraph (a)(8)(i) of this

section and that the other relevant requirements of paragraph (a) of this section are satisfied.

(iii) On January 1, 2014, the spot exchange rate is £1=\$2; the U.S. dollar LIBOR rate of interest is 9%; the market value of K's note in pounds has not changed; and K terminates swap #2. Because interest rates have increased from 8% to 9%, K will incur a loss of (\$.92) (the present value of the (\$1) difference between the 8% and 9% interest payments discounted at the current interest rate of 9%) with respect to the termination of such swap on January 1, 2014. Pursuant to paragraph (a)(6)(ii)(C) of this section, K must treat swap #1 as having been sold for its fair market value on the leg-out date, which is the date swap #2 is terminated. K must realize and recognize gain of \$100.92 (the present value of £110 discounted in pounds to equal £100 x \$2 (\$200) less the present value of \$108 (\$99.08)). The loss inherent in the pound borrowing from January 1, 2013 to January 1, 2014 is realized and recognized on January 1, 2014. Such loss is exchange loss in the amount of \$100 (the present value of £110 that was to be paid at the end of the year discounted at pound interest rates to equal £100 times the change in exchange rates: (£100 x \$1, the spot rate on January 1, 2013) - (£100 x \$2, the spot rate on January 1, 2014)). Pursuant to paragraph (a)(6)(ii)(E) of this section, except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the pound borrowing and currency swap cannot be part of a qualified hedging transaction for any period after the leg-out date.

(iv) Assume the facts are the same as in paragraph (iii) of this Example except that on January 1, 2014, the U.S. dollar LIBOR rate of interest is 7% rather than 9%. When K terminates swap #2, K will realize gain of \$0.93 (the present value of the (\$1) difference between the 8% and 7% interest payments discounted at the current interest rate of 7%) received with respect to the termination on January 1, 2014. Fifty percent or more of the remaining pound cash flow of the pound borrowing remains hedged after the termination of swap #2. Accordingly, under paragraph (a)(6)(ii)(F) of this section, paragraphs (a)(6)(ii)(B) and (C) of this section do not apply, and the gain on swap #1 and the loss on the qualifying debt instrument are not taken into account. Thus, K will include in income \$0.93 realized from the termination of swap #2.

(10) * * *

(iv) Effective/applicability dates for legging in and legging out rules. (A) The rules of paragraph (a)(6)(i) of this section are effective for qualified hedging transactions that are legged into after March 17, 1992.

(B) The rules of paragraph (a)(6)(ii) and Example 11 of paragraph (a)(9)(iv) of this section apply to leg-outs that occur on or after September 6, 2012.

* * * * *

§1.988-5 [Amended]

Par. 3. For each section listed in the table, remove the language in the “Remove” column and add in its place the language in the “Add” column as set forth below:

<u>Section</u>	<u>Remove</u>	<u>Add</u>
§1.988-5(a)(9)(iv), Example 4, paragraph (i), second, third and fourth sentences	January 1, 1990	January 1, 2013
§1.988-5(a)(9)(iv), Example 4, paragraph (i), table	December 31, 1990	December 31, 2013
§1.988-5(a)(9)(iv), Example 4, paragraph (i), table	December 31, 1991	December 31, 2014
§1.988-5(a)(9)(iv), Example 4, paragraph (i), table	December 31, 1992	December 31, 2015
§1.988-5(a)(9)(iv), Example 4, paragraph (iii)(B)	1990	2013
§1.988-5(a)(9)(iv), Example 4, paragraph (iii)(B)	1991	2014
§1.988-5(a)(9)(iv), Example 4, paragraph (iii)(B)	1992	2015
§1.988-5(a)(9)(iv), Example 4, paragraph (iii)(D), second sentence	1992	2015
§1.988-5(a)(9)(iv), Example 4, paragraph (iv), first, second, fourth, fifth, and sixth sentences	January 1, 1991	January 1, 2014
§1.988-5(a)(9)(iv), Example 4, paragraph (iv), first, fourth, and fifth sentences	January 1, 1990	January 1, 2013
§1.988-5(a)(9)(iv), Example 4, paragraph (iv), third sentence	1990	2013
§1.988-5(a)(9)(iv), Example 4, paragraph (iv), sixth and seventh sentences	December 31, 1992	December 31, 2015
§1.988-5(a)(9)(iv), Example 5, paragraph (i), second, fourth, and fifth sentences	January 1, 1990	January 1, 2013
§1.988-5(a)(9)(iv), Example 5, paragraph (i), table	December 31, 1990	December 31, 2013
§1.988-5(a)(9)(iv), Example 5, paragraph (i), table	December 31, 1991	December 31, 2014
§1.988-5(a)(9)(iv), Example 5, paragraph (i), table	December 31, 1992	December 31, 2015
§1.988-5(a)(9)(iv), Example	January 1, 1991	January 1, 2014

5, paragraph (ii), second and third sentences		
§1.988-5(a)(9)(iv), Example 5, paragraph (ii), second sentence	January 1, 1990	January 1, 2013
§1.988-5(a)(9)(iv), Example 5, paragraph (ii), third sentence	December 31, 1991	December 31, 2014
§1.988-5(a)(9)(iv), Example 5, paragraph (ii), third sentence	December 31, 1992	December 31, 2015
§1.988-5(a)(9)(iv), Example 5, paragraph (ii), third sentence	1991	2014
§1.988-5(a)(9)(iv), Example 5, paragraph (ii), third sentence	1992	2015
§1.988-5(a)(9)(iv), Example 5, paragraph (iii), second sentence	January 1, 1990	January 1, 2013
§1.988-5(a)(9)(iv), Example 5, paragraph (iii), second sentence	January 1, 1991	January 1, 2014
§1.988-5(a)(9)(iv), Example 5, paragraph (iii)(B)	1990	2013
§1.988-5(a)(9)(iv), Example 5, paragraph (iii)(B)	1991	2014
§1.988-5(a)(9)(iv), Example 5, paragraph (iii)(B)	1992	2015
§1.988-5(a)(9)(iv), Example 5, paragraph (iii)(C), first sentence	1990	2013
§1.988-5(a)(9)(iv), Example 5, paragraph (iii)(C), first sentence	1991	2014
§1.988-5(a)(9)(iv), Example 5, paragraph (iii)(C), first sentence	1992	2015
§1.988-5(a)(9)(iv), Example 5, paragraph (iii)(D), second sentence	1990	2013
§1.988-5(a)(9)(iv), Example 5, paragraph (iv), first, second, third, and sixth sentences	January 1, 1991	January 1, 2014
§1.988-5(a)(9)(iv), Example 5, paragraph (iv), fourth sentence	1990	2013

§1.988-5T [Removed]

Par. 4. Section 1.988-5T is removed.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: August 25, 2015.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

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