OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR RICHARD BLOOM
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FROM: LON SMITH
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CC:FIP

SUBJECT: - Hedging Transactions

This Chief Counsel Advice responds to your memorandum dated October 10, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

**LEGEND**

Taxpayer =

subsidiary =

facilities =

D =

E =

F =

G =

H =

I =

Year X =

Year Y =

Year Z =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Bank =

Trust =

beneficial holders of Trust =

Trust Notes =

a =

b =

c =
d =

e =

f =

g =

h =

i =

j =

k =

Formula X =

**ISSUES**

1. Should the Treasury rate lock agreement between Bank and Taxpayer be viewed as a hedging transaction entered into by Taxpayer and subject to the accounting rules of Treas. Reg. § 1.446-4?

2. Did Taxpayer suffer a loss that can be recognized under section 165 when it settled the Treasury rate lock agreement?

**CONCLUSIONS**

1. Based upon the statement presented in the incoming request, that the Treasury rate lock agreements were hedging the anticipatory bond issuance by Taxpayer, and support from some of the underlying documentation, we agree that the b rate lock agreements entered into on Date 4 were hedges and as such are

subject to the timing rules of Treas. Reg. § 1. 446-4.[1] The regulations specifically provide that for unfulfilled anticipatory transactions, such as an anticipated debt issuance that is not consummated, any gain or loss from that hedging transaction generally is taken into account when realized. Unless it can be established that the anticipated transaction was consummated by a different but similar transaction for which the hedge reasonably serves to reduce risk, the loss is taken into account when realized.

2. Under the facts presented, section 165 does not provide an independent basis to disallow the loss sustained when Taxpayer settled the Treasury rate lock agreement. Despite the fact that Taxpayer may not have suffered an economic loss overall when all the facts and circumstances of the transaction are viewed together (because of the rental expense savings), Taxpayer did suffer a loss on its valid hedging transaction.

## FACTS

In Year X , Taxpayer entered into certain sale/leaseback transactions in order to reduce its financing costs. The transactions involved sale-leasebacks to institutional investors of some of Taxpayer's undivided interests in two facilities. The term of the leases was for k years. Corporations D and E were established solely to provide financing for the transactions, which they did through the issuance of collateralized lease bonds (old bonds) through intermediaries to institutional investors. The source of the payments on the old bonds is the Taxpayer's unconditional obligation under the leases to make rent payments, which are used to make payments on the pledged lessor notes which in turn are the source for payments on the old bonds.

In Year Y, Taxpayer refinanced its obligations to reduce its financing costs. Taxpayer refinanced its obligations through new intermediaries (Corporations F and G), and new collateralized lease bonds (CLBs) were issued to the public. Although the source of funds to make payments on the new CLBs was Taxpayer's unconditional obligation to make rent payments, the CLBs are not direct obligations of Taxpayer, nor are they guaranteed by Taxpayer. Under the terms of the Participation Agreement in the initial sale/leaseback, the Taxpayer was prohibited from acquiring the CLBs, or the lessor notes issued in the Year X financing.

In Year Z, Taxpayer again determined that it could further reduce the financing costs for its facilities. Because of the prohibition against Taxpayer

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[1] See section below on Case Development for further discussion on additional facts that have raised some questions as to what Taxpayer may have intended to hedge and how that may affect this conclusion.

acquiring the CLBs, a simple refinancing was not possible. Bank approached Taxpayer with a refinancing plan that required repurchase of some of the outstanding CLBs through the use a of trust. The Bank also proposed some hedging strategies for Taxpayer relating to its issuance of long term bonds that were to fund the Trust's acquisition of the CLBs.

Under this plan, some of the outstanding CLBs would be acquired by Trust through Bank with use of a forward purchase contract whereby Bank was to purchase the CLBs on the open market, and hold them until the Trust was funded. The Trust had an obligation to purchase the CLBs, up to $ f . After several amendments to the date on which the Trust was required to purchase the CLBs, the Trust was funded on Date 5, the date the CLBs were purchased. Taxpayer had entered into an indemnification agreement with Bank, concurrent with the declaration of Trust whereby Taxpayer indemnified all liabilities and obligations of the Trust to Bank . On Date 4, Taxpayer and its subsidiary entered into a Transfer Agreement whereby Taxpayer transferred its beneficial interest in the Trust to its subsidiary. The Trust has a stated term of 30 years. On Date 5, the beneficial holders of the Trust made contributions to the capital of the Trust.

Taxpayer would contribute to the Trust most of the cash for the acquisitions, receiving a small amount of equity, plus debt obligations from the Trust (the Trust Notes) bearing interest at a rate approximate to the coupon rate of the reacquired CLBs. It was intended that Taxpayer would issue new debt in the form of first mortgage bonds (FMBs) in order to fund its obligations to the Trust at a lower interest rate. Under this plan Taxpayer would benefit from the difference between the interest rate it would pay on the FMBs, and the interest rate it would receive on the Trust Notes, which reflected the rate on the CLBs.

When the Trust received any payments on the CLBs (whether interest, principal or premium) the Trust is directed first to make any payments on amounts due and owing on the Trust Notes, and second to make distributions of the remaining amounts to the beneficial holders in accordance with the terms of the holder's securities. The Trust Notes are the obligations of the Trust. The Trust issued a series of i variable rate Trust Notes (each note related to one of the i series of CLBs acquired by the Trust). Interest was paid in arrears, semi-annually for each of the Trust Notes. The payment of principal was designed to mirror the cashflow from the CLBs. The payments were termed as H. Payments are made on the Trust Notes to reflect the payments received by the Trust on the CLBs. If the Trust sold the CLBs, the corresponding Note tranche is to be prepaid in an I. The interest rate on the Trust Notes was established at an initial per annum interest rate with the interest rate to be reset on the first interest payment due date following the j month after the note was issued. A formula rate was determined for calculating the new interest rate.[2] Subsequent interest rate reset dates fell on the first interest payment due date that was more than i years from the previous interest rate reset.

Since Taxpayer planned to fund the Trust with long-term debt (FMBs), it had a risk that interest rate volatility would eliminate any rate savings which it hoped to realize by the repurchase of the CLBS. In order to hedge Taxpayer's interest rate exposure during the period between the acquisition of CLBs and the issuance of the FMBs, Bank suggested Taxpayer enter a Treasury Rate Lock Agreement, whereby Taxpayer would enter into a rate lock hedge every time CLBs were repurchased. Bank and Taxpayer entered into a Master Forward Treasury Rate Lock Agreement on Date 1. The master agreement controlled the relevant terms for each hedging transaction except for the actual interest rate lock and actual settlement date, which was set forth in separate confirmations as each interest rate lock was set. The rate lock agreement provided that if the interest rate on treasuries is above the locked-in rate at a specified date, the Bank will make an adjustment payment to Taxpayer to offset the cost of issuing at a higher rate. If however, the rates on treasuries is below the locked-in rate, Taxpayer makes an adjustment payment to Bank. During the CLB open market repurchase period (Date 2 through Date 3), Taxpayer entered into a rate lock transactions with Bank. The unwind date for the transactions was Date 4 and the settlement date was Date 5.

On Date 5, when the Trust was first obligated to purchase the CLBs, the first set of rate lock agreements unwound with no payment due from either side. However, because Taxpayer was not ready to issue FMBs, b additional rate lock agreements were entered into.[3] The proceeds from the FMBs were to be used to extinguish the short term borrowing facility which supplied $c to the Trust to purchase the CLBs from Bank pursuant to the forward contract between the parties. Due to a decrease in the yield of treasury notes, on Date 6 (unwind date) and Date 7 (settlement date), Taxpayer incurred a loss on the rate locks for the period d in excess of e, the amount which Taxpayer paid to Bank. The field has

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[2] The determination of the formula rate is based upon the yield of U.S. Treasury Notes of applicable maturity taken from the Wall Street Journal for the previous business day. The formula rate was calculated pursuant to Formula X. Notwithstanding the formula rate, each tranche of Trust Notes had a floor establishing the minimum per annum interest rate borne by the Trust Note.

[3] For business reasons, the Taxpayer never did issue the FMBs, and instead paid its obligations to the Trust with other funds generated internally and through an extension and resizing of a one year bank facility.

determined that the Trust had an unrealized gain of h on the CLBs purchased on Date 5 over the same period d.

For financial purposes, Taxpayer is amortizing the e loss over the life of the Trust Notes. The refinancing is shown as reducing the rental obligation by the income stream received from the Trust Notes, with the income stream being reduced by the hedge loss amortized over the life of the income stream. For tax purposes, Taxpayer claimed the loss on the rate lock agreements as a short term capital loss in Year Z. [4] Taxpayer only claimed g of the capital loss on its Year Z return, then carried back the loss to an earlier year return and then forward to two later year returns. Taxpayer identified the loss on its Schedule D as "bond hedging transactions."

**LAW AND ANALYSIS**

Issue 1 - Hedging Transaction

Treas. Reg. § 1.1221-2(b) defines a hedging transaction to include a transaction entered into in the normal course of the taxpayer's trade or business primarily to reduce risk of interest rate changes with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.[5]

Treas. Reg. § 1.1221-2(c)(1)(i) provides that determining whether a transaction reduces risk is based upon "all the facts and circumstances surrounding the taxpayer's business and the transaction. In general, a taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions reduce the taxpayer's risk."

Treas. Reg. § 1.1221-2(c)(6) provides that whether hedges of a taxpayer's debt issuances (borrowings) are hedging transactions is determined without regard to the use of the proceeds of the borrowing.

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[4] In the incoming facts, it is stated that Taxpayer claims that it was hedging the Trust "Bonds" by entering into the b additional rate lock agreements. See incoming request at p. 15. It is unclear what is being referred to as "Trust bonds. " From other statements and documents in the materials sent to us, it appears that Taxpayer was claiming to hedge the anticipated FMBs. See attachments 19, but see also attachments 12.

[5] Section 1221(a)(7) of the Code was added pursuant to section 532 of the Ticket to Work and Work Incentives Improvement Act of 1999 (113 Stat. 1860). It is effective for transactions entered into on or after December 17, 1999, and thus does not apply to the year in issue.

According to your facts, the repurchase program was undertaken by Taxpayer to reduce the amount of the rent that had to be paid on the sale/leasebacks. A factor of the rent expense was the interest being paid on the CLBs, which expense was above market for other forms of long-term financings. Because Taxpayer was prohibited from directly reacquiring the CLBs, it could not simply refinance. Instead a repurchase of the CLBs was done by the Trust. Taxpayer, by lending money so that the CLBs could be repurchased by the Trust, was able to reduce the effective amount of rent being paid by it due to the income stream coming to Taxpayer on the long-term Trust Notes given to it by the Trust. See incoming FSA request at p. 19.

As part of the refinancing done through the repurchase program, Taxpayer also entered into Treasury rate lock agreements to reduce the risk that interest rate fluctuations would increase the cost of the FMBs that were to be issued by the Taxpayer as part of the refinancing. Taxpayer entered into the Treasury rate lock agreements to hedge against the possible increase in cost of its anticipatory borrowings. From the time of the purchase of the CLBs until Taxpayer issued its FMBs, Taxpayer was subject to interest rate exposure. Taxpayer claims to have used a hedging strategy to try to eliminate this volatility. Every time CLBs were repurchased a hedge was executed, locking in net present value savings (NPV).

In this case, it appears from the facts presented that the Treasury rate lock agreements were entered into to reduce the risk of interest rate fluctuations on the borrowings which Taxpayer planned to issue, the FMBs.[6] Between the time the CLBs were repurchased by the Trust and the time when the FMBs were to be issued there was interest rate volatility and any NPV savings achieved by the repurchase might be lost. Assuming that the Treasury rate lock agreement reduced Taxpayer's risk of interest rate fluctuations, the agreement would constitute a hedging transaction under Treas. Reg. § 1.1221-2(b).[7]

<u>Identification of Hedges - Character of Gain or Loss</u>

The regulations also require that a taxpayer identify its hedging transaction and this identification must be made before the close of the day on which the

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[6] See discussion in incoming request and promotional materials from Bank regarding the hedging strategies to be used for repurchase and refinancing program. However, there are some additional materials prepared by Taxpayer that have added confusion to the issue. See discussion in Case Development section.

[7] See Case Development section below for factual development and an analysis of hazards of litigation discussion for position that treasury rate lock agreements are economic hedges for the rental expenses generated by the leases.

taxpayer enters into the transaction. Treas. Reg. § 1.1221-2(e)(1). Generally the identification must identify the item or aggregate risk being hedged, which in turn also requires identification of a transaction that creates risk and the type of risk that transaction creates. Treas. Reg. § 1.1221-2(e)(2)(i). The timing of the identification described in paragraph (e)(2) must be substantially contemporaneous with entering into the hedging transaction. The regulations provide that an identification is not substantially contemporaneous if it is made more than 35 days after entering into the hedging transaction. Treas. Reg. § 1.1221-2(e)(2)(ii).

The regulations under paragraph (e)(3) provide further identification requirements for specific types of hedge transactions, including hedging of debt to be issued. If the hedging transaction relates to the expected issuance of debt by the taxpayer, the following information must be made in the identification of the hedge: the expected date of issuance of the debt; the expected maturities; the total expected issue price of the issue; and the expected interest provisions. If the hedge is for less than the expected term of the debt or less than the expected issue price, the identification must include the amount or the term being hedged. Treas. Reg. § 1.1221-2(e)(3)(iii)(B).

Treas. Reg. § 1.1221-2(e)(4) require that the identification be made on and be retained as part of the taxpayer’s books and records. The regulations further provide that the presence or absence of the identification must be unambiguous. The identification for financial accounting and regulatory purposes does not satisfy this requirement unless the taxpayer’s books and records indicate that the identification is also being made for tax purposes.

Treas. Reg. § 1.1221-2(f)(2) provides that if a transaction is not identified as required by paragraph(e)(1) then that establishes that the transaction is not a hedging transaction and the character of the gain or loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose. Treas. Reg. § 1.1221-2(b) may not require the identification of the transaction as a hedging transaction in the manner as set forth in Treas. Reg. § 1.1221-2(e)(1) for a transaction to be a hedging transaction. However identification is relevant to determine the character of the transaction. Identification is required for the taxpayer to receive ordinary loss treatment.

The incoming request states that Taxpayer did not identify this transaction as a hedging transaction related to debt to be issued as required by the regulations under § 1.1221-2(e)(1). We agree with your analysis that the failure to identify the transaction as a hedge means that Taxpayer cannot treat the loss as ordinary. Taxpayer did treat its loss from the Treasury rate lock agreements as short term capital loss, it did not claim ordinary loss.[8]

Timing Rules for Hedges

Another question raised in your incoming request was whether the accounting rules of Treas. Reg. § 1.446-4 apply to this transaction. They do apply to hedging transactions and under our assumed facts, we have concluded that this is a hedging transaction.

Under Treas. Reg. §1.446-4(b), 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 being hedged. The regulations go on to note that taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions.

Treas. Reg. § 1.446-4(e)(4) provides that gains or losses from hedges of debt instruments issued or to be issued by a taxpayer must be accounted for by reference to the terms of the debt instrument and the periods to which the hedge relates.

Treas. Reg. § 1.446-4(e)(8) sets forth specific requirements for unfulfilled anticipatory transactions, specifically the regulation provides that if a taxpayer enters into a hedging transaction to reduce risk with respect to a debt issuance and the anticipated transaction is not consummated, any income, deduction, gain or loss from the hedging transaction is taken into account when realized. The regulation further provides that a taxpayer consummates a transaction for purposes of paragraph (e)(8)(i) upon the occurrence (within a reasonable interval around the expected time of the anticipated transaction) of either the anticipated transaction or a different but similar transaction for which the hedge serves to reasonably reduce risk. Treas. Reg. § 1.446-4(e)(8)(ii).

We agree with your conclusion that the timing rules of Treas. Reg. § 1. 446-4 do apply; however we do not agree that the loss from the hedging transaction should be spread over the life of the Trust Notes or over the remaining lease terms. Your analysis was based upon the overall effect of the refinancing - which reduced the rent expense for Taxpayer, and the fact that the planned borrowings did not take place. Since there were no FMBs to reference when accounting for

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[8] See discussion below in Case Development section regarding conflicting facts and concerns regarding Taxpayer's treatment of the loss as capital.

the timing of the loss and to match the hedging loss with the rent deduction, you argue that the loss should be spread over the remaining lease terms or the terms of the Trust Notes. We disagree. Treas. Reg. § 1.446-4(e)(8) specifically provides for the situation where anticipated debt is not issued and it provides for that gain or loss to be taken into account when realized. We do not think the situation is one where the requirements of Treas. Reg. § 1.446-4(e)(8)(ii) for looking to the Trust Notes or the lease agreement as a "similar transaction" are met.

If it can be established that there was a "consummation" of the anticipated transaction by a different, but similar, transaction for which the hedge serves to reasonable reduce risk, as described in Treas. Reg. § 1.446-4(e)(8)(ii), then the loss may be spread over the period to which the hedge relates. In other words, the rules set forth under Treas. Reg. § 1.446-4(e)(4) may apply. The incoming request seems to suggest an argument may be made that, since the rental expenses were reduced by this transaction, and that "economically" the Treasury rate locks were really hedging the lease payments, then under Treas. Reg. § 1.446-4(e)(4), the loss should be spread over the terms of the lease. We disagree. Our reading of the provision under Treas. Reg. § 1.446-4(e)(8)(ii) regarding "different but similar transaction" contemplates that a different current transaction is entered into instead of the anticipated transaction and the section does not apply to a preexisting debt obligation or transaction, such as a preexisting lease.

If you are arguing that the "different but similar transaction" arises from the payment to the Trust from internally generated funds and the extension of and resizing of the short-term bank facility used to pay the Trust the funds used to acquire the CLBs, then we need further factual development. We do not think that internally generated cash funds can be used under this provision. If it can be established that all or parts of the "resized" and extended bank facility is the "different but similar transaction," then the loss may be spread over the period of the resized note. See further discussion under Case Development section.

Issue 2 - Section 165 Loss

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(b) provides, in part, that for a loss to be allowable as a deduction under section 165(a), it must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Further, Treas. Reg. § 1.165-1(b) provides that only a bona fide loss is allowable and that substance and not mere form shall govern in determining a deductible loss.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), rev'g 890 F.2d 848 (6th Cir. 1989), the Supreme Court held that the taxpayer realized losses from the exchange of economically similar pools of mortgages. In doing so the Court, stressing the bona fides of the transactions, reversed the Sixth Circuit's holding that, although realized, the loss was not actually sustained for purposes of section 165.

In Shoenberg v. Commissioner, 77 F.2d 446 (8th Cir. 1935), cert. denied, 296 U.S. 586 (1935), the taxpayer sold stock in his personal account at a loss, and directed his investment company to purchase identical stock. The replacement stock was later transferred to the taxpayer. The court disallowed the loss, concluding that the taxpayer's economic position had not changed, and to be deductible a loss must be actual and real. In ACM Partnership v. Commissioner, 157 F.3d 231 (3rd Cir. 1998), the court determined that the taxpayer's losses did not correspond to any actual economic losses, and therefore were not bona fide for purposes of section 165.

Courts have denied losses in prearranged option-straddle transactions designed to generate a loss for tax purposes, while deferring an offsetting gain, on the grounds that such transactions lacked economic substance. Lerner v. Commissioner, 939 F.2d 44 (3rd Cir. 1991) cert. denied, 502 U.S. 984 (1991), Yosha v. Commissioner, 861 F.2d 494 (7th Cir. 1988), aff'g Glass v. Commissioner, 87 T.C. 1087 (1986).

In Rev. Rul. 2000-12, 2000-1 C.B. 744, the taxpayer purchases two debt instruments with identical terms. The interest rates on the notes are contingent. A reset event will cause one note's yield to double, and the second note's yield to be reduced to zero. The ruling holds that a loss on the sale of the zero rate note, which is substantially offset by unrealized gain on the other note, is artificial and not allowable under section 165.

In this case the bona fides of the overall transaction has not been questioned. According to the field, Taxpayer issued the original CLBs in order to reduce the cost of financing its facilities—not, as in Rev. Rul. 2000-12, in order to generate tax losses. It entered into the repurchase transaction for the same reason, and, as part of that transaction, hedged its interest rate exposure by entering into the rate lock agreements.[9]

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[9] The court in ACM Partnership recognized that hedging interest rate risk exposure can be a valid non-tax reason for a transaction; however, the court found that the actual transactions engaged in by the taxpayer in ACM "impeded rather than advanced" that professed goal. See 157 F.3d at 255-56. Here, by contrast, according to the field memorandum, at 19, "The Treasury rate lock agreement was entered into to

The field argues that the Taxpayer did not suffer a loss with respect to the rate lock agreements because the cash it paid under the rate lock agreement was compensated for by the income it received from the Trust over time. But all hedging transactions, by definition, involve a balancing of gain and loss. Section 165 itself does not operate to disallow losses from bona fide transactions simply because they are hedging transactions; on the contrary, hedging losses are commonplace. See, e.g., Treas. Reg. § 1.1221-2. Since there appear to be valid non-tax motivations for entering into the rate lock transactions, section 165 itself does not operate to deny the losses.

## CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

As discussed above there may be some clarification warranted as to what Taxpayer was hedging when it entered into the additional rate lock agreements that generated the loss. The incoming request states that Taxpayer was hedging the interest rate fluctuations that could have increased the cost of its anticipated borrowings, the FMBs. This information is supported by materials prepared by the Bank setting out the hedging strategy it recommended to Taxpayer. That material is clear that the hedge relates to the issuance of the FMBs. Also, in an IDR response, Taxpayer describes its second hedge contracts, the hedges at issue here, as entered into to protect the effective issuance cost of the anticipated FMBs.

However in response to another IDR, Taxpayer describes the hedges in terms of protecting its "anticipated investment." Taxpayer seems to be claiming to be hedging the Trust Notes. Also attached to this same IDR response was an internal memo dated Date 8, that raises these same questions as to what the Taxpayer is hedging. Again the memo mentions an anticipated investment and refers to hedging of Trust Notes. Transactions that do not reduce risk are not hedging transactions. Treas. Reg. § 1.1221-2(c)(3) provides that no investments can be hedging transactions. However, the Treasury rate lock agreement could hedge the Trust Notes. It is possible that this could change our position that this is not a hedge, but the end result would probably be no different in that it gives rise to a capital loss.

There is also a handwritten notation on the bottom of the memo stating that for the hedging transactions, a section 1231 short- term capital loss should be reported for tax purposes. [redacted]

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reduce the risk that interest rate fluctuations would increase the cost of the first mortgage bonds that were to be issued by [Taxpayer] as part of the planned refinancing."

[redacted]

[redacted] There are two exceptions to the identification rule for hedges for purposes of determining the character of the gain or loss. One of the exceptions applies to inadvertent errors. Paragraph (f)(2)(ii) of this regulation provides that in the case of inadvertent error if a taxpayer did not make an identification that satisfies the requirements of paragraph(e) of this section, the taxpayer may treat gain or loss from the transaction as ordinary income or loss under paragraph (a)(1) or (a)(2) of Treas. Reg. § 1.1221-2 if -

(A) The transaction is a hedging transaction (as defined in paragraph (b) of that section;

(B) The failure to identify the transaction was due to inadvertent error; and

(C) All of the taxpayer's hedging transactions in all open years are being treated on either original or, if necessary, amended returns as provided in paragraphs (a)(1) and (a)(2) of that section.

The other exception is the anti-abuse rule of paragraph (f)(2)(iii). That rule provides that if a taxpayer does not make an identification that satisfies all the requirements of paragraph (e) of that section but the taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then gain from the transaction is ordinary. Thus, a taxpayer may not elect to treat gain or loss from a hedging transaction as capital gain or loss. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (b) of the section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

It appears unlikely that short term debt from the resized bank facility would be sufficiently similar to the anticipated long term FMBs to be picked up by Treas. Reg. § 1.446-4(e)(8)(ii).

We think the transaction itself does not appear to be an attempt to generate tax losses but rather is a valid attempt to reduce financing costs. The structure does not appear to be set up tor tax advantage purposes or to be solely tax driven, but rather necessary in light of the restrictions in the participation Agreement prohibiting Taxpayer from reacquiring the CLBs and therefore preventing a more straightforward refinancing.

Integration Question

The incoming request raised two specific issues regarding integrated transactions under Treas. Reg. § 1.1275-6: (1) Was the acquisition of the Trust Notes after the effective date of Treas. Reg. § 1.1275-6; and (2) whether the agent looks only to the two treasury rate lock transactions entered into on Date 4, or does he look at all the treasury rate lock transactions entered into pursuant to the Master Treasury Rate Lock Agreement when determining whether a qualifying debt instrument and a financial instrument should be integrated? Before we can answer any specific questions on the application of Treas. Reg. § 1.1275-6, we need to know what position the Service is considering. Is the Service arguing that this should be a transaction that is integrated by the Commissioner? Are the Trust Notes or the CLBs to be considered the qualifying debt instruments? Is the financial instrument the treasury rate lock agreements? It is difficult to answer questions in a vacuum, and it can lead to more confusion than clarification. We will be glad to provide supplemental advice should you decide to pursue this further and provide us with some specifics on the underlying issue.

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Please call if you have any further questions.

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