



TAX AND ACCOUNTING FOR DERIVATIVES: TIME FOR RECONCILIATION

by Steven M. Rosenthal and Mark H. Price

I. Introduction

The time of reckoning for derivatives draws near, although not as near as originally proposed. Last year, the Financial Accounting Standards Board¹ issued Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*.² The standard superseded three prior FASB pronouncements and modified several others.³ The FASB originally scheduled FAS 133 to take effect for entities whose fiscal years begin after June 15, 1999 (January 1, 2000 for calendar year entities). Last month, the FASB deferred the effective date for companies that have not already implemented FAS 133 by one year, thus making FAS 133 effective for fiscal years beginning after June 15, 2000 (January 1, 2001, for calendar year entities).⁴

FAS 133 applies to all reporting entities, including not-for-profit organizations.⁵ Generally, FAS 133 re-

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This article introduces FAS 133, the new accounting standard for derivatives and hedges, and then presents the tax rules applicable to these instruments. The article then compares and discusses the differences, both theoretical and practical, that will arise from the implementation of FAS 133. The article suggests that some reconciliation is possible and desirable.

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¹The FASB is the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. The Securities and Exchange Commission and the American Institute of Certified Public Accountants officially recognize FASB standards as authoritative. For more information, see generally FASB, *Facts About FASB* (visited July 19, 1999) <http://www.rutgers.edu/Accounting/raw/fasb/facts/index.html>.

²*Accounting for Derivative Instruments and Hedging Activities*, Statement of Financial Accounting Standards No. 133 (Financial Accounting Standards Bd. 1998) [hereinafter FAS 133].

³The three FASB pronouncements that are superseded are *Accounting for Futures Contracts*, Statement of Financial Accounting Standards No. 80 (Financial Accounting Standards Bd. 1984), *Disclosure of Information About Financial Instruments With Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, Statement of Financial Accounting Standards No. 105 (Financial Accounting Standards Bd. 1990), and *Disclosure About Derivative Financial Instruments and Fair Value of Financial Instruments*, Statement of Financial Accounting Standards No. 119 (Financial Accounting Standards Bd. 1994).

⁴See *Accounting for Derivative Instruments and Hedging Activities — Deferral of the Effective Date of Statement No. 133 — An Amendment of FASB Statement No. 133*, Statement of Financial Accounting Standards No. 137 (Financial Accounting Standards Bd. 1999).

⁵Not-for-profit organizations are subject to special rules, which will not be discussed in this article.

quires companies to carry derivatives at their fair value⁶ and to recognize gains or losses currently in earnings (i.e., to mark to fair value). FAS 133 also permits companies, in appropriate situations, to elect hedge accounting, under which a company generally may mark a hedged item to fair value (in addition to the hedging derivative).⁷

The drafting of FAS 133 was a long and involved process.

The new accounting standard for derivatives will inevitably conflict with the U.S. federal income tax treatment of these items. The tax treatment of derivatives is scattered across the Internal Revenue Code of 1986 (the "code").⁸ Some taxpayers must mark these instruments (and others) to their fair market value⁹ annually, including the changes in value in taxable income. Some derivative instruments are marked to market regardless of the taxpayer. Other derivative instruments are accounted for annually based on their periodic and nonperiodic cash flows. In certain circumstances, derivatives must be treated as hedges and realized gains and losses must be subjected to special timing rules. In other circumstances, two or more derivatives may be combined and treated, in effect, as a single instrument. The more transparent and consistent, but rigid, treatment afforded derivatives for financial accounting purposes is likely to generate administrative complexities when combined with the current tax treatment, which is much less consistent, although, in some cases, more flexible.

This article introduces the new financial accounting standard, discussing its scope and its effect. The article also presents the tax rules applicable to derivatives and hedges. The article then compares the treatment of derivatives under FAS 133 and tax. Finally, the article discusses the differences, both theoretical and practical, that will arise from the implementation of FAS 133. The article further suggests that some reconciliation is possible and desirable.

⁶Fair value is defined as the amount at which an asset (or liability) can be bought (or incurred) or sold (or settled) in a current transaction between willing parties, other than in a forced sale or liquidation. See FAS 133, para. 540.

⁷As discussed below, in the case of a cash flow hedge, the hedged item is not marked to fair value.

⁸Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and all Treasury regulation references are to the regulations promulgated thereunder.

⁹"Fair market value," under the tax rules, is defined strikingly similarly to "fair value" under financial reporting. That is, "fair market value" of property generally is defined as "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 sell and both having reasonable knowledge of relevant facts." Treas. reg. section 1.170A-1(c)(2); e.g., Treas. reg. sections 20.2031-1(b), 25.2512-1. Compare the definition of "fair value" for accounting purposes, set forth in note 6, *supra*.

II. FAS 133

A. Background

The drafting of FAS 133 was a long and involved process. The FASB added the project to its agenda in 1986 to address financial reporting issues arising from the use of more exotic financial instruments. The FASB and its staff issued several reports, memoranda, and statements over the next six years addressing the financial accounting and reporting issues arising from financial instruments.¹⁰ The FASB began considering the financial accounting treatment of derivatives and hedging in January 1992 and issued an exposure draft in June 1996. The FASB received comments on the exposure draft, held public hearings, and, in 1997, deliberated again in light of the comments. The FASB circulated a new draft for comment in August 1997. Ten months later, the FASB issued the final statement. Even after its issuance, the public and the Derivatives Implementation Group¹¹ continue to raise significant implementation questions, resulting, in part, in the postponement of the effective date.¹²

With FAS 133, the FASB intended to address four problems with previous accounting and reporting practices.

With FAS 133, the FASB intended to address four problems with previous accounting and reporting practices: (i) the effect of derivatives was not transparent in basic financial statements; (ii) the accounting guidance for derivative instruments and hedging activities was incomplete; (iii) the accounting guidance for derivative instruments and hedging activities was inconsistent; and (iv) the accounting guidance for derivatives and hedging was difficult to apply.¹³ The FASB acted on these concerns about the accounting and disclosure requirements for derivatives and hedging activities in light of their increased use and complexity in recent years, and the growing per-

¹⁰See FAS 133, paras. 207-09.

¹¹The Derivatives Implementation Group (DIG) is a task force that was created to help the FASB answer questions that will arise when companies begin implementing FAS 133. The DIG identifies practice issues that arise from applying the requirements of FAS 133 and advises the FASB on how to resolve those issues. The DIG's recommendations are recorded by the FASB staff and are considered by the FASB, but are not generally accepted accounting practice. The recommendations, however, help the FASB in developing such practice.

¹²In explaining the reason for delaying the effective date of FAS 133, the FASB cited concerns about reporting entities' ability to modify their information systems and educate their managers in time to apply the rules in FAS 133. The FASB also cited the impact of year 2000 systems issues as a basis for the delay. See FASB, *FASB Delays Implementation Date for Derivatives and Hedging Standard* (issued July 7, 1999) <http://www.rutgers.edu/Accounting/raw/fasb/news/index.html>.

¹³See FAS 133, paras. 234-37.

ception that accounting standards have not kept pace with those changes.¹⁴

Through its lengthy deliberation process, the FASB developed a new framework for the reporting of derivatives and hedging. This framework is premised on the following four "fundamental decisions":

- Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported in financial statements.
- Fair value is the only relevant measure for derivative instruments.
- Only items that are assets or liabilities should be reported as such in financial statements.
- Special hedge accounting should be provided, but should be limited to transactions involving changes in fair values or cash flows for the risk being hedged.¹⁵

The FASB considers FAS 133 a step that is "intended to address immediate problems about the recognition and measurement of derivatives." In the future, however, the FASB plans to pursue "the Board's vision of having all financial instruments measured at fair value in the statement of financial position."¹⁶ Thus, more change is expected.

B. What Are Derivatives?

1. **In general.** The FASB abandoned its former practice of identifying derivatives by name, and now defines a derivative based only on its characteristics. The FASB expects this approach to make FAS 133 more adaptable to future financial innovation.¹⁷ To prevent an overly broad application of FAS 133, the FASB enumerated certain scope exceptions to the definition of a derivative. Under this new approach, certain contracts, such as loan commitments, are excluded, while other instruments that are not treated as derivatives under current standards are included.

FAS 133 defines a derivative instrument as a financial instrument or other contract that:¹⁸

- Has (i) one or more underlyings¹⁹ and (ii) one or more notional amounts or payment provisions or both, which determine the settlement amount;²⁰
- Requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would

be expected to have similar responses to changes in market factors;²¹ and

- Permits or requires net settlement.²²

A financial instrument or contract must satisfy each characteristic to be a derivative.

The FAS 133 definition of a derivative applies to a variety of contracts. For example, a contract satisfies the net settlement requirement even if the contract only permits net settlement in default.²³ The definition may therefore sweep in contracts that require physical delivery of commodities. Similarly, the definition could include stock purchases where delivery occurs in the future.

The FASB decided to exclude some contracts from FAS 133. Accordingly, the FASB carved out certain contracts, including "regular-way" security trades, normal purchases and normal sales, traditional insurance contracts, and most financial guarantee contracts.²⁴ In addition, certain contracts, such as instruments indexed to a company's own stock and classified in stockholders' equity, are not considered to be derivative instruments for purposes of FAS 133.²⁵

2. **Embedded derivatives.** The FASB was concerned that some companies might try to avoid FAS 133 treatment by embedding a derivative in a nonderivative financial instrument.²⁶ Under current financial ac-

²¹See FAS 133, para. 8. A contract's initial net investment must be compared to other instruments (e.g., the purchase of an asset with which the underlying is associated) that have similar responses to changes in market factors. See *id.*; cf. FAS 133, para. 256 (providing an example of the net investment test). This requirement does not disqualify a currency swap that requires an exchange of currency. See FAS 133, para. 257.

²²The net settlement requirement can be satisfied in three different ways. The contract can explicitly require net settlement in cash or by delivery of an asset not associated with the underlying, whether or not it is readily convertible to cash. Alternatively, net settlement exists where there is an established market mechanism that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost. Lastly, the net settlement requirement is satisfied if the contract requires delivery of an asset that is readily convertible to cash, including actively traded securities, or is itself a derivative instrument. See FAS 133, paras. 9, 57(c).

²³See FAS 133, para. 57(c)(1); see also Statement 133 Implementation Issue No. A5 (released May 1999) [hereinafter DIG Issue].

²⁴See FAS 133, para. 10. FAS 133 also excludes over-the-counter derivative contracts with certain underlyings (e.g., physical or unique nonfinancial assets). See FAS 133, para. 10(e); DIG Issue No. C5 (cleared Feb. 1999). Interest-only and principal-only strips are also excluded if (a) they initially resulted from separating the rights to receive contractual cash flows of a nonderivative financial instrument and (b) they do not incorporate any terms not present in the original financial instrument. See FAS 133, para. 14.

²⁵See FAS 133, para. 11.

²⁶See FAS 133, para. 293. An embedded derivative is an implicit or explicit term that affects some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative. See FAS 133, para. 12. The combination of an embedded derivative and a host contract is referred to as a hybrid instrument. Some examples of hybrid contracts are structured notes, convertible securities, and securities with caps, floors, or collars. See FAS 133, para. 61.

¹⁴See FAS 133, para. 212.

¹⁵See FAS 133, para. 3.

¹⁶FAS 133, para. 216 (emphasis added).

¹⁷See FAS 133, para. 248.

¹⁸See FAS 133, para. 6.

¹⁹See FAS 133, para. 7. An underlying is broadly defined to be a referenced price, rate, or other variable, such as interest rates, security and commodity prices, or indexes. See FAS 133, paras. 7, 57(a), 250. This variable must be observable and objectively verifiable. See FAS 133, para. 57(a).

²⁰See FAS 133, para. 7.

counting standards, companies rarely account separately for embedded derivative instruments, a practice that has led to some perceived abuse.²⁷ FAS 133 changes this practice.

Under FAS 133, companies must separate certain derivatives from their host contracts for financial accounting purposes and treat them as freestanding derivatives subject to the rules of FAS 133, but only if the embedded derivative meets three requirements. First, the embedded contract must not be clearly and closely related to the host contract.²⁸ Second, the hybrid instrument must not be carried at fair value through earnings under other general accounting principles. Finally, a freestanding instrument with the same terms as the embedded derivative must satisfy the definition of a derivative set forth above.²⁹

If a company must separate an embedded derivative from the host contract and the company can reliably identify and measure the embedded derivative, the company must account for the host contract under general accounting standards for similar contracts and subject the embedded derivative to FAS 133. The company may designate the embedded derivative as a hedging instrument if it otherwise qualifies as such. If a company cannot reliably identify and measure the embedded derivative, the company must mark the entire contract to fair value through earnings and may not designate the contract as a hedging instrument.³⁰

C. Financial Accounting for Derivatives

1. In general. The FASB decided that derivatives are assets or liabilities that should be carried on the balance sheet and should be measured at fair value. Accordingly, FAS 133 requires a company to recognize its derivative instruments on its balance sheet as either assets or liabilities. FAS 133 further requires a company to mea-

²⁷See FAS 133, para. 297. The FASB specifically mentioned structured notes as an example of a product structured to provide purportedly more favorable accounting treatment by embedding a derivative. *See id.*

²⁸An embedded derivative satisfies the "not clearly and closely related" standard if its economic characteristics and risks are not clearly and closely related to the economic characteristics and risks of the host contract. A company performs this test by examining both the underlying and the host contract. *See generally* FAS 133, paras. 60-61. For example, a debt host contract would generally be clearly and closely related to an embedded derivative with an underlying based on interest, inflation, or creditworthiness. A debt contract would not be clearly and closely related, however, to an embedded derivative with an underlying based on the price of a share of the debtor's stock (e.g., convertible debt). The holder of the debt would have to separate the embedded derivative from the host contract, unless the security was held in a trading portfolio. The issuer of this debt would not, however, separate the embedded contract from the host. *See* FAS 133, para. 11(a) (excluding derivatives that are indexed to a company's own stock and that are classified in shareholders' equity).

²⁹See FAS 133, para. 12.

³⁰See FAS 133, para. 16.

sure these derivatives at fair value.³¹ The gain or loss on a derivative not designated as a hedge is recognized currently in earnings.³² The gain or loss on a hedge, and corresponding hedged item, is discussed below.

Companies must disclose certain information about their derivatives activities. Companies must generally describe their objectives for holding or issuing the derivative instruments, the context needed to understand those objectives, and their strategies for achieving those objectives. For derivative instruments that are not designated as hedges, companies must describe the purpose of the derivative activity. In the case of hedging instruments, companies must describe their risk management policies for each type of hedge, including descriptions of the hedged items or transactions.³³ Companies must also make certain quantitative disclosures of their hedging activities.³⁴

A properly identified fair value hedge must be 'highly effective' to qualify for hedge accounting.

2. Hedges and hedged items. One major effect of marking derivatives to fair value through earnings is to increase earnings volatility and to create fluctuations in the balance sheet. When a company uses a derivative as a hedge, however, the changes in value of the derivative generally offset economically changes in value related to the risk being hedged. Accordingly, FAS 133 generally permits companies to use hedge accounting when they use derivatives to hedge assets, liabilities, firm commitments, or forecasted transactions.

In general, under the hedge rules, a company currently recognizes gain or loss from a derivative that it identifies as a hedge but may recognize an offsetting loss or gain on the hedged item attributable to the risk being hedged (other than cash flow hedges). Thus, the net effect of this accounting is to reflect currently in earnings changes in the fair value of a hedge to the extent the hedge is not effective in achieving offsetting changes in the fair value of the hedged item.

The FASB explicitly rejected the use of "synthetic instrument" accounting, which views two or more distinct financial instruments as having synthetically created another single cash instrument, which is accounted for accordingly.³⁵ The FASB rejected synthetic accounting to be consistent with (i) the fundamental decision to report all derivatives in the financial statements, (ii) the fundamental decision to measure all derivatives at fair value, (iii) the objective to increase

³¹See FAS 133, para. 17. For guidance on the measurement of fair value of a financial instrument, *see generally* *Disclosures About Fair Value of Financial Instruments*, Statement of Financial Accounting Standards No. 107 (Financial Accounting Standards Bd. 1991).

³²See FAS 133, para. 18.

³³See FAS 133, para. 44.

³⁴See FAS 133, para. 45.

³⁵See FAS 133, para. 350.

the transparency of derivatives and derivative activities, and (iv) the objective of providing consistent accounting for all derivative instruments and for all hedging strategies.³⁶

FAS 133 permits, but does not require, companies to use hedge accounting. FAS 133 also permits companies to de-designate a hedge at any time. If a company de-designates a hedge, or the hedging relationship ceases, the company reverts to standard accounting for the derivative and the formerly hedged item.³⁷

FAS 133 permits hedge accounting for three types of hedges: fair value hedges, cash flow hedges, and foreign currency hedges.

a. Fair value hedges. Fair value hedges are hedges of the exposure to changes in fair value of a recognized asset or liability or of an unrecognized firm commitment attributable to a particular risk.³⁸ If effective, changes in the derivative economically offset changes in the hedged item attributable to the risk being hedged. The hedge accounting rules attempt to mirror this effect for accounting purposes.³⁹

Companies can hedge one or more of the following risks of financial assets or liabilities (or nonfinancial firm commitments with financial components): price risk, currency risk, interest rate risk, or credit risk.⁴⁰ Companies can hedge only price risk or currency risk attributable to nonfinancial assets and liabilities.⁴¹ An example of a fair value hedge is a fixed rate-to-floating rate swap that hedges the fair value of a fixed-rate note.

A company that elects to apply hedge accounting must document at the inception of the hedge the following information:

- The entity's risk management objective and strategy for undertaking the hedge;
- Identification of the hedged instrument and the hedged item;
- The nature of the risk being hedged; and
- How effectiveness will be assessed.⁴²

This information is in addition to the general disclosure information about the company's derivatives activities. Companies must make certain periodic quantitative disclosures relating generally to the amount of gain or loss attributable to hedge ineffectiveness.⁴³

A properly identified fair value hedge must be "highly effective" to qualify for hedge accounting. "Highly effective" has been interpreted to mean that a hedge must offset 80 to 125 percent of the changes in fair value of the hedged item attributable to the identified risk being hedged.⁴⁴ Ineffectiveness may arise from a variety of sources, including differences between notional amounts and principal amounts, different maturity or repricing dates, time value premiums, and different underlying interest rate bases.⁴⁵

Companies must satisfy the effectiveness test at inception as well as on an ongoing basis. Companies must continue to measure effectiveness whenever earnings are reported and at least quarterly. If a company determines that the hedge is no longer effective, the company must prospectively discontinue fair value hedge accounting. The company is not required, however, to make any adjustments to its accounting treatment of the derivative and the hedged item before this failure of the effectiveness test.⁴⁶

Companies must demonstrate the effectiveness requirement under FAS 133 with respect to each item (or portion thereof). Companies may hedge a portfolio only if the individual assets or liabilities share the same risk exposure for which they are designated as being hedged.⁴⁷ Companies, however, can isolate a portion of a hedged item and hedge that portion. For example, a company can hedge a percentage of an asset, selected cash flows, or an embedded option that is not separated from the host contract.⁴⁸

Under fair value hedge accounting, a company marks to fair value the hedging instrument (i.e., the derivative) on its balance sheet and recognizes the changes in value in earnings. The company also marks to fair value the hedged item on the balance sheet, but only for changes in value attributable to the risk being hedged. The company also recognizes these changes currently in earnings.⁴⁹ If the hedge is fully effective, the gain or loss on the hedge should completely offset the loss or gain on the hedged item. Any difference is a result of ineffectiveness and, however small, is currently recognized in earnings. A company accounts for the adjustment made to the carrying amount of a hedged asset or liability in the same manner as other components of the carrying amount of the asset or liability. Thus, the adjustment would remain part of the

³⁶See *id.*

³⁷See FAS 133, paras. 25, 26, 32, 33.

³⁸See FAS 133, para. 4(a). A recognized asset or liability is defined as an asset or liability recorded on the balance sheet. A firm commitment has the characteristics of an asset or liability and must be specific as to price, quantity, and timing. The contract must be with an unrelated party and must be binding on both parties. Firm commitments are usually legally enforceable. The contract must also be probable of performance due to a significant disincentive for nonperformance.

³⁹See FAS 133, para. 362.

⁴⁰See FAS 133, para. 21(f).

⁴¹See FAS 133, para. 21(e).

⁴²See FAS 133, para. 20(a).

⁴³See FAS 133, para. 45(a).

⁴⁴The FASB intends "highly effective" to be essentially the same as the notion of high correlation in FAS 80. See FAS 133, para. 389. The range of 80 to 125 percent has emerged through practice as the interpretation of that standard.

⁴⁵Companies can exclude certain components of a hedging derivative's change in fair value from the assessment of hedge effectiveness. See FAS 133, paras. 20(a)(2), 63. This portion must be included currently in earnings and must be separately identified in the financial statements. See FAS 133, paras. 45(a)(1), 63.

⁴⁶See FAS 133, paras. 25, 26.

⁴⁷See FAS 133, para. 21(a)(1).

⁴⁸See FAS 133, para. 21(a)(2).

⁴⁹See FAS 133, para. 22.

carrying amount until the asset is sold (e.g., in the case of inventory) or it might be amortized to earnings.⁵⁰

b. Cash flow hedges. FAS 133 also permits hedge accounting for cash flow hedges. A cash flow hedge is a hedge against the exposure to variability in expected cash flows of a recognized asset or liability or a forecasted transaction⁵¹ due to an identified risk.⁵² Some companies may attempt to reduce such variability, even at the cost of increased volatility in shareholders equity.

Companies can hedge one or more of the following risks of existing (or forecasted purchases or sales of) financial assets or liabilities: total cash flow risk, currency risk, interest rate risk, or credit risk.⁵³ Companies can hedge only total cash flow risk or currency risk attributable to nonfinancial assets and liabilities.⁵⁴ An example of a cash flow hedge is a floating rate-to-fixed rate swap that is used to hedge interest payments from a floating-rate debt.

Cash flow hedges are available only for certain forecasted transactions. A company can hedge a forecasted transaction only if it is probable of occurrence,⁵⁵ if it does not involve the acquisition of an asset or the incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings,⁵⁶ and if it presents an exposure to variations in cash flow that could affect earnings.⁵⁷ Moreover, a company can hedge only a forecasted transaction that is entered into with a party external to the reporting entity.⁵⁸

Cash flow hedges also must be "highly effective." This phrase has the same meaning for cash flow hedges and fair value hedges and must be assessed at the same times and with the same frequency.⁵⁹

Companies must identify cash flow hedges at inception of the hedge, and must describe the same type of information that is required for fair value hedges (i.e., risk management objective and strategy, the nature of the hedged risk, the derivative hedging instrument, the hedged forecasted transaction, and the method of as-

sessing effectiveness).⁶⁰ In addition, companies must disclose information about the hedged forecasted transaction, including the date on or period within which the company expects the forecasted transaction to occur, the specific nature of the asset or liability involved, and the expected currency amount or quantity of the forecasted transaction.⁶¹ As with fair value hedges, companies must make periodic quantitative and qualitative disclosures regarding the derivative, the hedged forecasted transaction, and hedge ineffectiveness.⁶²

The accounting treatment of qualifying cash flow hedges is more complex than fair value hedges. In general, companies must carry derivatives in cash flow hedges at fair value on the balance sheet. Companies must generally report the effective portion of the hedge through other comprehensive income.⁶³ Companies must report the ineffective portion through earnings. Hedge ineffectiveness occurs when the cumulative gain or loss on the derivative hedging instrument exceeds the cumulative change in the expected future cash flows on the hedged transaction.⁶⁴ Companies must reclassify amounts that are classified in other comprehensive income into earnings when the hedged transaction affects earnings. This can occur all at once, in the case of a forecasted sale or purchase, or over time, in the case of depreciable property.⁶⁵

c. Foreign currency hedges. Companies have foreign currency exposure whenever they have transactions, assets, liabilities, or net investments in operations denominated in a nonfunctional currency. FAS 133 excludes most hedges of foreign currency from the hedging rules because they are measured through earnings under Statement of Financial Accounting Standards No. 52, *Foreign Currency Translation*.⁶⁶ There are, however, certain enumerated situations where fair value or cash flow hedging of foreign currency risk is permitted under FAS 133. Additionally, FAS 133 permits hedges of a company's net investment in a foreign operation.

There are two permissible fair value hedges: currency risk hedges of unrecognized firm commitments and currency risk hedges of available-for-sale securities. A company must generally satisfy the requirements for establishing and maintaining a qualifying hedging transaction. In the case of available-for-sale securities, the security must not be exchange-traded in the

⁵⁰See FAS 133, para. 24.

⁵¹A forecasted transaction is a transaction that is expected to occur for which there is no firm commitment. A forecasted transaction is a transaction that will occur at prevailing market prices. Thus, a forecasted transaction generally cannot be reported on the balance sheet. See FAS 133, para. 540.

⁵²See FAS 133, para. 28.

⁵³See FAS 133, para. 29(h).

⁵⁴See FAS 133, para. 29(g).

⁵⁵See FAS 133, para. 29(b). The term "probable" requires a significantly greater likelihood of occurrence than the phrase "more likely than not." See FAS 133, para. 464.

⁵⁶See FAS 133, para. 29(d). The cash flow hedging rules also are restricted in the case of debt securities classified as held-to-maturity. With respect to these forecasted transactions, the risk being hedged must be the risk of changes in cash flows attributable to default or changes in creditworthiness of the issuer. See FAS 133, para. 29(e).

⁵⁷See FAS 133, para. 29(c).

⁵⁸See *id.*

⁵⁹See FAS 133, para. 28(b).

⁶⁰See FAS 133, para. 28(a).

⁶¹See FAS 133, para. 28(a)(2).

⁶²See FAS 133, para. 45(b).

⁶³See FAS 133, paras. 18(c), 30. Other comprehensive income is the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. See FAS 133, para. 540.

⁶⁴See FAS 133, paras. 30(b), 380.

⁶⁵See FAS 133, para. 31.

⁶⁶*Foreign Currency Translation*, Statement of Financial Accounting Standards No. 52 (Financial Accounting Standards Bd. 1981).

investor's functional currency and the instrument must be a single-currency instrument.⁶⁷

Companies also may enter into certain types of foreign currency cash flow hedges. Companies can enter into hedges of forecasted third-party and inter-company sales, purchases, royalty payments, and other forecasted transactions denominated in a foreign currency.⁶⁸ FAS 133 places certain requirements and limitations on these hedges.⁶⁹

A company may also designate a derivative instrument as hedging the foreign currency exposure of a net investment in a foreign operation.⁷⁰ A company reports the gain or loss of a hedging derivative instrument that is designated as, and is effective as, an economic hedge of net investment in the same manner as a translation adjustment.⁷¹

3. Transition issues. FAS 133 requires a shift from current accounting practices. The transition to FAS 133 will require an adjustment of items on the balance sheet. Generally, the transition rules require a company to make the adjustments necessary to bring the statement of financial position into compliance with FAS 133. For example, a company must measure the carrying amounts of freestanding derivatives on the balance sheet at fair value. The company must treat the adjustments necessary to bring the balance sheet into compliance as transition adjustments. Companies must report these adjustments through other comprehensive income or earnings, as appropriate.⁷²

The transition rules also permit companies to move securities between categories thus enabling them to hedge items that otherwise are not hedgeable under FAS 133. Thus, companies may transfer held-to-maturity securities into the available-for-sale category or the trading category. Companies may transfer available-for-sale securities into the trading category.⁷³

The result of the transition rules may be a significant one-time change in the balance sheet and, possibly, earnings. The new accounting standard may also result in a series of recategorizations of securities to optimize their treatment.

D. Summary

FAS 133 sets forth a new approach to accounting for derivatives and hedging transactions. In general, FAS 133 requires companies to recognize all derivatives on

the balance sheet at fair value. A company must mark the changes in fair value of the derivatives through earnings, except for certain hedges. Under the hedging rules, companies may, in appropriate circumstances, also mark a hedged risk to fair value.

The FASB expects users of financial reports to benefit from the increased transparency of reporting entities' derivatives operations. This transparency will come at the cost of increased volatility in earnings and on the balance sheet, as changes in the value of derivatives are accounted for every period. The hedge accounting rules should limit this volatility in the limited circumstances where hedge accounting is permitted.

III. Tax Rules for Derivatives and Hedges

The tax rules for the timing of gains and losses from derivatives vary considerably, and depend greatly on the context.⁷⁴ Some taxpayers must mark these instruments (as well as others) to their fair market value annually, including the changes in value in taxable income. Some derivative instruments are marked to market regardless of the taxpayer. Other derivative instruments are accounted for annually based on their periodic and nonperiodic cash flows. In certain circumstances, derivatives must be treated as hedges and subjected to special timing rules. In other circumstances, two or more derivatives may be combined and treated, in effect, as a single instrument. Set forth below are the general tax rules applicable to derivatives (including swaps, which are described under the tax rules as notional principal contracts) and the special tax rules applicable to tax hedges.

A. General Tax Rules for Derivatives

1. Section 475. Section 475 sweeps in the broadest range of derivatives. Congress added this section to the code in the Revenue Reconciliation Act of 1993,⁷⁵ and expanded it considerably in the Taxpayer Relief Act of 1997.⁷⁶ As enacted in 1993, section 475 applied only to securities dealers (as defined below). Section 475 requires these securities dealers to use a mark-to-market method of accounting for their securities. Under this method, dealers must include all of their securities in inventory at fair market value, and thereby recognize unrealized gain or loss.⁷⁷ The section generally requires dealers that own securities that are not inventory to treat those securities as sold at fair market value on the last day of the tax year, and to recognize gain or loss

⁶⁷See FAS 133, paras. 37, 38. Unlike the standard rules for fair value hedging, companies can use *nonderivative* financial instruments to hedge foreign currency risk in the two situations discussed above. See FAS 133, paras. 37-38. The gain or loss on nonderivative hedging instruments attributable to foreign currency risk is considered foreign currency transaction gain or loss under FAS 52.

⁶⁸See FAS 133, para. 40.

⁶⁹See *id.*

⁷⁰Companies can also hedge net investments using non-derivative financial instruments that may give rise to foreign currency transaction gain or loss under FAS 52.

⁷¹See FAS 133, para. 42.

⁷²See generally FAS 133, paras. 49-56.

⁷³See FAS 133, para. 54.

⁷⁴This article focuses only on the timing of income for derivatives under the tax rules, and not the character (capital or ordinary) of this income. These character rules may, however, be important. For corporate taxpayers, in particular, the capital character matters because of the rules that permit corporations to deduct capital losses only to the extent of capital gains. Congress limited deductions for these losses principally because of concerns on the timing (or selective realization) of the losses. See 2 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, ch. 50, at 4 n.5 (2d ed. 1990).

⁷⁵Pub. L. No. 103-66, 107 Stat. 312.

⁷⁶Pub. L. No. 105-34, 111 Stat. 788.

⁷⁷See section 475(a)(1).

for that year (i.e., mark the securities to market at the end of each year).⁷⁸ A dealer may exempt certain securities that are held for investment, that are not held for sale, or that are hedges of either of these categories of securities, but, in general, only if the dealer properly identified the securities as exempt on the date of acquisition.⁷⁹ Congress required securities dealers to adopt a mark-to-market method of accounting because it believed that method most clearly reflected their income. In addition, Congress reasoned that securities dealers generally could easily value their securities at market at year-end and, in fact, did value their securities at market for financial reporting purposes.⁸⁰

The expansion of section 475 reflects, in part, Congress's determination that mark-to-market most clearly reflects income for assets that are traded in established markets.

A securities dealer is defined broadly to include a taxpayer that (i) regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business, or (ii) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.⁸¹ This definition is quite expansive and includes, for example, taxpayers such as banks because they regularly make and sell loans.

Securities include nonderivatives (e.g., stock, certain partnership interests, and debt instruments), interest rate, currency, and equity notional principal contracts, and other derivative financial instruments. This definition is expansive, although it generally excludes contracts that are marked to market under section 1256 (e.g., regulated futures contracts and foreign currency contracts). As a result, a dealer must mark to market most financial instruments, absent a special exemption.⁸²

In 1997, Congress permitted securities traders and commodities dealers and traders to elect mark-to-market treatment for their securities and commodities, respectively.⁸³ A taxpayer may separately elect the mark-to-market method of accounting for each of its securities or commodities trades or businesses. The expansion of section 475 reflects, in part, Congress's determination that mark-to-market most clearly reflects income for assets that are traded in established markets.⁸⁴

2. Options, forwards, futures and section 1256 contracts. In general, a taxpayer recognizes gains and losses from options, forwards, and futures contracts

based on general income tax principles (such as the realization principle⁸⁵), and not special tax statutes or regulations (except for section 1256 contracts as described below). No gain or loss generally is realized, or deductible expense permitted, on the purchase of an option. Any premium, commission, or fee is a non-deductible capital expenditure that becomes a purchaser's basis in the option.⁸⁶ A taxpayer realizes gain or loss to the extent that the sales price or closing transaction price exceeds, or is less than, its basis in the option. If a taxpayer exercises an option, the taxpayer must add the cost to the basis of the property purchased (or its cost reduces the amount realized on a sale of the underlying property in determining gain or loss).⁸⁷

The timing of gains and losses for forward contracts generally is the same as the timing of gains and losses for options. That is, entering into a forward contract generally is not a taxable event, and prepayments are not includible in income at the time of receipt.⁸⁸ Gain or loss is realized on the settlement or termination of the contract (or the disposition of the underlying property). Some futures contracts are subject to special rules in section 1256.

Section 1256, enacted in 1981,⁸⁹ provides that gain or loss from regulated futures contracts must be reported under a mark-to-market rule on an annual basis, regardless of the taxpayer. In general, regulated futures contracts are contracts that are traded on or subject to the rules of a qualified board or exchange.⁹⁰ Congress reasoned that regulated futures contracts should be marked-to-market because a taxpayer who trades futures contracts receives profits as a matter of right or must pay losses in cash daily, and, thus, measuring income on the same basis for tax purposes is appropriate.⁹¹ As a result of subsequent legislation, foreign currency contracts, nonequity options, and dealer equity options are also subject to the mark-to-market regime under section 1256.⁹²

3. Notional principal contract regulations (Treas. reg. section 1.446-3). The timing of gains and losses from certain derivatives known as "notional principal contracts" is subject to special regulations that were promulgated in 1993 under Treasury's authority to prescribe general rules for methods of accounting.⁹³

⁸⁵Under general income tax principles, a taxable event that would give rise to gain or loss does not occur until a sale or disposition occurs. See *Eisner v. Macomber*, 252 U.S. 189, 207 (1920).

⁸⁶See Rev. Rul. 58-234, 1958-1 C.B. 279.

⁸⁷See Rev. Rul. 78-182, 1978-1 C.B. 265.

⁸⁸A relatively new statute, section 1259, treats certain forward contracts as constructive sales of the underlying property in some instances.

⁸⁹Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, section 503(a), 95 Stat. 172, 323.

⁹⁰See section 1256(g)(1).

⁹¹See Staff of Joint Comm. on Tax'n, 97th Cong., *General Explanation of the Economic Recovery Tax Act of 1981*, at 295-96 (Comm. Print 1981).

⁹²See section 1256(b).

⁹³See T.D. 8491, 1993-2 C.B. 215.

⁷⁸See section 475(a)(2).

⁷⁹See section 475(b)(1), (2).

⁸⁰See H.R. Rep. No. 103-111, at 661 (1993).

⁸¹See section 475(c)(1).

⁸²See section 475(c)(2).

⁸³See generally section 475(e), (f).

⁸⁴See Staff of Joint Comm. on Tax'n, 105th Cong., *General Explanation of Tax Legislation Enacted in 1997*, at 180 (Comm. Print 1997).

The Treasury intended these regulations to enable clear reflection of the income and deductions from notional principal contracts by prescribing accounting methods that reflect the economic substance of such contracts.⁹⁴

A notional principal contract is defined as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts."⁹⁵ Notional principal contracts include interest rate swaps, currency swaps, basis swaps, caps, floors, and similar arrangements. Notional principal contracts do not include section 1256 contracts, futures, forwards, and options. The regulations are also preempted by sections 475 and 988.⁹⁶

Traditionally, the tax rules do not bifurcate embedded derivatives.

The timing of income from notional principal contracts depends on whether the cash flow is a periodic or nonperiodic payment. In general, periodic payments are payments paid or received that are payable at intervals of one year or less during the entire term of the contract.⁹⁷ All taxpayers must recognize the ratable daily portion of a periodic payment for the tax year to which that portion relates.⁹⁸

A nonperiodic payment is any payment made or received with respect to a notional principal contract that is not a periodic payment or a termination payment.⁹⁹ All taxpayers must recognize the ratable daily portion of a nonperiodic payment for the tax year to which that portion relates. Generally, a taxpayer must recognize a nonperiodic payment over the term of a notional principal contract in a manner that reflects the economic substance of the contract. The exact manner in which the payment is recognized depends on the

type of notional principal contract and the method chosen to recognize the payment.¹⁰⁰ Termination payments generally are recognized on the termination event.¹⁰¹

By contrast to the rules under sections 475 and 1256, the rules that apply to notional principal contracts generally are based on annual accruals (of both periodic and nonperiodic payments), and not changes in fair market value.

4. Foreign currency derivatives. In general, under section 988, foreign currency derivatives are subject to the timing rules otherwise applicable to derivative instruments. Thus, the timing rules for foreign currency derivatives are found in other places, such as the notional principal contract regulations and section 1256. As a result, income or loss from foreign currency notional principal contracts is generally included for tax purposes based on the ratable daily accruals of periodic and nonperiodic payments. Income or loss from foreign currency futures and contracts is generally included for tax purposes on an annual mark-to-market basis.¹⁰²

5. Contingent debt regulations. Traditionally, the tax rules do not bifurcate embedded derivatives. Instead, the tax rules adopt a "wait-and-see" approach to the taxation of these complex derivatives. Under the "wait-and-see" approach, income generally is not recognized until actual payment. In 1996, however, the IRS adopted rules for certain types of contingent debt (i.e., debt instruments that provide for contingent payments), which may include debt instruments with embedded derivatives. These rules set forth several methods of accounting for contingent debt instruments.¹⁰³

The principal method of accounting for contingent debt instruments is the noncontingent bond method. This method is generally applicable to any contingent payment debt instrument that is issued for cash or publicly traded property.¹⁰⁴ Under the noncontingent bond method, the issuer of a contingent debt obligation must determine a comparable yield for the debt instrument and a projected payment schedule assuming that yield. The issuer and the holders then must currently accrue annual interest rate expense and income based on that schedule. The issuer and the holders must make adjustments for differences between projected contingent payments and actual contingent payments.¹⁰⁵

Nonpublicly traded contingent debt instruments that are issued for nonpublicly traded property are not subject to the noncontingent bond method. Instead,

⁹⁴See Treas. reg. section 1.446-3(b).

⁹⁵Treas. reg. section 1.446-3(c)(1)(i). The two key phrases in the definition of a notional principal contract are "specified index" and "notional principal amount." A specified index is broadly defined as a fixed rate, price, or amount; a rate, price, or amount that changes in different periods; an index based on objective financial information; and certain interest rate indices. See Treas. reg. section 1.446-3(c)(2). A notional principal amount is any specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract, but is not borrowed as part of the contract. See Treas. reg. section 1.446-3(c)(3).

⁹⁶See Treas. reg. section 1.446-3(c)(ii)-(iv). For a brief discussion of section 988, see text accompanying note 102, *infra*. The hedging rules may also preempt these special timing rules for notional principal contracts, in circumstances where the rules conflict. See Treas. reg. section 1.446-4(g)(2).

⁹⁷See Treas. reg. section 1.446-3(e)(1).

⁹⁸See Treas. reg. section 1.446-3(e)(2).

⁹⁹See Treas. reg. section 1.446-3(f)(1).

¹⁰⁰See Treas. reg. section 1.446-3(f)(2), (g)(4).

¹⁰¹See Treas. reg. section 1.446-3(h)(2). Special rules apply for notional principal contracts that are used as hedges.

¹⁰²See Treas. reg. section 1.988-2(d)(2), (d)(3), (e)(1). There are special rules for the treatment of currency swaps. These rules treat currency swaps as hypothetical borrowings and account for taxable income accordingly. See Treas. reg. section 1.988-2(e)(2).

¹⁰³See Treas. reg. section 1.1275-4(a)(1).

¹⁰⁴See Treas. reg. section 1.1275-4(b)(1).

¹⁰⁵See Treas. reg. section 1.1275-4(b).

these instruments may be bifurcated into a noncontingent portion and a contingent portion. The noncontingent payments are treated as a standard debt instrument. The contingent payments are treated as part principal and part interest when paid.¹⁰⁶

B. Tax Rules for Hedges

Taxpayers that use derivative instruments in hedging transactions generally must use hedge accounting for tax purposes. In general these rules require a taxpayer to match reasonably 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.¹⁰⁷ There are three different tax hedging regimes — the general tax hedging rules, the debt integration rules, and the foreign currency integration rules.

1. General tax hedging rules. Treas. reg. section 1.1221-2(b) sets forth the definition of a hedging transaction for tax purposes.¹⁰⁸

A hedging transaction is a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily

(1) To reduce risk of price changes or currency fluctuations with respect to ordinary property . . . that is held or to be held by the taxpayer; or

(2) To reduce risk of 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, by the taxpayer.

This definition sets forth several important rules for hedging transactions.

A hedging transaction must be entered into primarily to reduce risk, which is determined based on all of the facts and circumstances. The tax rules generally permit micro- and macro-hedges, as well as partial term hedging.¹⁰⁹ A taxpayer thus can hedge either a specific risk or an aggregate risk. Additionally, a taxpayer can hedge all or any portion of its risk for all or any portion of the period of the risk.¹¹⁰

In addition, the tax rules require a hedge to reduce price risk or currency risk with respect to ordinary property or interest rate risk, price risk, or currency

risk with respect to debt issuances and ordinary obligations of the taxpayer. Ordinary property is property that could not produce capital gain or loss in the hands of a taxpayer.¹¹¹ Most taxpayers cannot, therefore, use the hedging transaction rules for hedges of equity or debt securities held for investment.¹¹² Taxpayers may hedge debt issuances regardless of the use of the proceeds.¹¹³

In general, a taxpayer cannot hedge cash flows standing alone. In the preamble to the temporary hedging regulations, the IRS explained that "the regulations do not apply where a taxpayer hedges a dividend stream, the overall profitability of a business unit, or other business risks that do not relate directly to interest rate or price changes or currency fluctuations."¹¹⁴

A taxpayer must properly identify a hedging transaction, or be subject to an "anti-abuse" rule.¹¹⁵ The taxpayer must identify the hedging transaction before the close of the day on which the taxpayer enters into the transaction.¹¹⁶ The taxpayer also must identify the hedged item, the transaction creating the risk, and the type of risk being created no more than 35 days after entering into the hedging transaction.¹¹⁷ An identification for financial accounting purposes is not sufficient unless the books and records indicate that the hedge is being made for both purposes.¹¹⁸ A taxpayer must make these identifications and retain them as part of its books and records.¹¹⁹

A taxpayer must account for a hedging transaction by a method that "clearly reflects income." To reflect income clearly, 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.¹²⁰

These special timing rules do not apply to securities marked to market under section 475(a), integrated debt transactions, or section 988 hedging transactions.¹²¹ In addition, a taxpayer generally must account for notional principal contracts under the rules that are generally applicable to those instruments, unless those rules would not result in the matching that is needed to satisfy the clear reflection requirement for hedging transactions.¹²² The hedging transaction timing rules, however, do apply to properly identified section 1256 contracts.¹²³

¹⁰⁶See Treas. reg. section 1.1275-4(c).

¹⁰⁷See FI-54-93, 1993-2 C.B. 615, 616.

¹⁰⁸Pending legislation would codify these regulations, and expand the definition of a hedge to manage risk, not just to reduce risk. See Taxpayer Refund Act of 1999, S. 1429, 106th Cong., section 1306 (passed by the Senate on July 29, 1999); Financial Freedom Act of 1999, H.R. 2488, 106th Cong., section 205 (passed by the House of Representatives on July 22, 1999).

¹⁰⁹In theory, a taxpayer may hedge only enterprise risk, not micro-risks. Nevertheless, the IRS will respect a hedge of a particular asset or liability if it reduces the risk attributable to the asset or liability and if the hedge is reasonably expected to reduce the risk of the taxpayer's overall operations. See Treas. reg. section 1.1221-2(c)(1)(ii).

¹¹⁰See Treas. reg. section 1.1221-2(c)(1)(iv).

¹¹¹See Treas. reg. section 1.1221-2(c)(5).

¹¹²There is an exception for banks and similar financial institutions. Such institutions must treat all debt securities as ordinary property. See section 582(c).

¹¹³See Treas. reg. section 1.1221-2(c)(6).

¹¹⁴T.D. 8493, 1993-2 C.B. 255, 257.

¹¹⁵See Treas. reg. section 1.1221-2(f)(2)(iii).

¹¹⁶See Treas. reg. section 1.1221-2(e)(1).

¹¹⁷See Treas. reg. section 1.1221-2(e)(2).

¹¹⁸See Treas. reg. section 1.1221-2(e)(4)(ii).

¹¹⁹See Treas. reg. section 1.1221-2(e)(4)(i).

¹²⁰See Treas. reg. section 1.446-4(b).

¹²¹See Treas. reg. section 1.446-4(a)(2).

¹²²See Treas. reg. section 1.446-4(e)(5).

¹²³See section 1256(e)(1).

The effect of the general tax hedging rules is to time income or loss based on the timing of a hedged item. In general, there is no ability, or requirement, to mark-to-market or otherwise change the timing of the gains and losses from the hedged item. In addition, a taxpayer need not make an ongoing evaluation of the effectiveness of a hedge.

2. Integrated debt transactions. A taxpayer may integrate hedges of qualifying debt instruments with the corresponding debt instrument under Treas. reg. section 1.1275-6. A taxpayer may then treat the integrated hedge and debt instrument as one instrument for tax purposes.¹²⁴ Under limited circumstances, the IRS may integrate a taxpayer's hedges, notwithstanding the lack of a taxpayer identification.¹²⁵

A financial instrument may qualify as a hedge only if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. In addition, a financial instrument may qualify as a hedge only if the resulting synthetic debt instrument has the same term as the remaining term of the qualifying debt instrument.¹²⁶

Unlike the hedging rules, which respect the separate nature of the hedge and the hedged item, the integrated debt transaction rules record the two instruments as one synthetic instrument for tax purposes (so that some attributes, like the sourcing of the interest payments, will automatically be netted).¹²⁷ A taxpayer then determines gain or loss and interest expense or income based on the performance of the synthetic debt instrument.¹²⁸

3. Foreign currency hedging transactions. For the most part, the general hedging rules apply to foreign currency hedging transactions. As a result, the timing of hedges of foreign currency risk are matched with the timing of hedged items, provided the item is ordinary property, an ordinary obligation, or a borrowing. Special rules exist to integrate certain foreign currency debt instruments with appropriate hedges (a "section 988 hedging transaction"). As in the case of integrated debt transactions, the foreign currency hedging rules are available only where a high degree of correlation exists between the hedge and the debt instrument. If the requirements for a section 988 hedging transaction are satisfied, the two instruments are integrated and treated as single borrowing in a single currency.¹²⁹

IV. Financial Accounting vs. Tax Accounting

As discussed below, there are significant differences between the treatment of derivatives under FAS 133 and the tax rules.

A. What Are Derivatives?

FAS 133 defines the term "derivative" based on its characteristics. A derivative must have an underlying and a notional amount or payment provision, a comparatively small net investment, and a net settlement provision. The FASB believes that these characteristics typify current derivatives and provide flexibility for future financial innovation. Thus, FAS 133 provides a uniform definition for derivatives.

There are significant differences between the treatment of derivatives under FAS 133 and the tax rules.

By contrast, the tax rules provide no uniform definition of a "derivative." The notional principal contract regulations provide a functional definition of a notional principal contract that includes elements similar to those in the FAS 133 definition. However, the notional principal contract definition excludes many contracts, such as forwards, options, and futures that are generally considered to be derivatives. Because of the different treatment of different derivatives, categorizing a financial instrument is important under the tax rules. This task, however, is often difficult.

The financial accounting rules also extend their reach to embedded derivatives, in order to provide uniform accounting for all derivatives. FAS 133 generally separates an embedded derivative from the host contract and treats the embedded derivative as a freestanding derivative unless it is clearly and closely related to the host contract, or the entire contract is currently marked through earnings. By contrast, the tax rules rarely bifurcate financial instruments, preferring a "wait-and-see" approach generally for these instruments. Only the contingent debt regulations address embedded derivatives, but in a limited manner (applying to certain debt instruments only) and in a varied fashion (requiring current accruals of projected payments in some instances and a "wait-and-see" approach for others).

B. What Is the Accounting for Derivatives?

FAS 133 requires a reporting entity to value its derivatives at fair value on the balance sheet and generally to report any changes through earnings. This mark-to-fair-value regime generally applies to all derivatives subject to FAS 133.¹³⁰ Companies must value their securities for interim and year-end financial statements, which should result in quarterly valuations.

By contrast, under the tax rules, the timing rules vary for different derivative instruments and for different activities of the company. Section 475 generally requires securities dealers and other electing com-

¹²⁴See Treas. reg. section 1.1275-6(f).

¹²⁵See Treas. reg. section 1.1275-6(c)(2).

¹²⁶See Treas. reg. section 1.1275-6(b)(2).

¹²⁷See Treas. reg. section 1.1275-6(f).

¹²⁸See Treas. reg. section 1.1275-6(f)(1).

¹²⁹See generally Treas. reg. section 1.988-5(a).

¹³⁰Cash flow hedges and foreign currency hedges of net investments in foreign operations are reported through other comprehensive income. These are some of the few exceptions to the general rule of marking through earnings that are applicable to derivatives.

panies to mark their securities to market annually, but gives these taxpayers the option to exclude certain derivatives from this treatment.¹³¹ Excluded derivatives, as well as any derivatives held by companies that are not securities dealers, are accounted for either on a mark-to-market basis, an accrual of cash flow basis, or a realization basis. A derivative may be marked to market if it is a section 1256 contract. Otherwise, the derivative's periodic and nonperiodic payments are generally accrued under the notional principal contract regulations, without a mark to market. A derivative that is neither a notional principal contract nor a section 1256 contract may be subject to general realization-based tax rules.

C. What Are Hedges?

FAS 133 enumerates three types of hedges — fair value, cash flow, and foreign currency hedges — and then outlines the risks that may be hedged under each method. A reporting entity can use the hedging rules under FAS 133 for hedges of most assets and liabilities, including assets that would be considered capital assets for tax purposes. Hedge accounting is not available for certain risks of held-to-maturity debt securities.

The tax rules for hedges set forth a general definition of a hedge: a hedge reduces certain types of risk from certain types of assets and liabilities. Tax hedging treatment is limited to price risk and currency risk for ordinary property and price risk, currency risk, and interest rate risk for borrowings and ordinary obligations. These risks are commonly associated with fair value changes. The tax rules generally do not permit cash flow hedges, except for hedges of variable rate indebtedness.

Under FAS 133, hedge accounting is available only if the company can establish that the hedge is "highly effective" in reducing the risk being hedged. This effectiveness must then be assessed at least quarterly. A hedge that ceases to be highly effective no longer qualifies for hedge accounting treatment.

By contrast, tax hedging requires only that a hedge be entered into "primarily" to reduce risk. In general, the term "primarily" means "of first importance" or "principally."¹³² The taxpayer assesses an instrument only at the time of entering into the transaction.

The more rigid requirements of FAS 133 stem, in large part, from the fact that hedge accounting is elective and relies on management's intent.¹³³ By contrast, under the tax hedging rules, hedge accounting is mandatory (i.e., if a hedge exists, it must be identified).

Finally, with respect to identification, FAS 133 and tax both require information to be disclosed regarding the hedge and the hedged item. FAS 133 generally requires companies to provide the entity's risk management objective and strategy for undertaking the hedge at inception, to identify the hedged instrument and the

hedged item, to describe the nature of the risk being hedged, and to set forth in reasonable detail an explanation of how effectiveness will be assessed. This disclosure supplements the disclosures that are generally required to be made for a company's derivative activities.

Taxpayers must identify hedging transactions on the day on which they are entered. A taxpayer must identify the hedged item, the transaction creating the risk, and the type of risk being created within 35 days. A taxpayer cannot simply rely on an identification for FAS 133 purposes to establish a valid tax hedge. In addition to the specific information, the taxpayer must provide a description of the tax accounting method used for each type of hedging transaction and must provide whatever additional information is necessary to verify the application of the method of accounting used.

D. What Is the Accounting for Hedges?

Before the promulgation of FAS 133, hedge accounting was "commonly thought of as the practice of deferring recognition of realized or unrealized gains (or losses) on the hedged item or losses (or gains) on the hedging instrument that otherwise would not be deferred because of a relationship that is thought to exist between a hedging instrument and the hedged item."¹³⁴ As has been observed, however, "hedge accounting also can refer to the current recognition of gains (or losses) from the hedging instrument and losses (or gains) on the hedged item; that occurs if the hedged item and the hedging instrument are marked to market and changes therein are reported in income. Under either a deferral or mark-to-market approach, hedge accounting results in symmetry between the accounting for the hedged item and the hedging instrument."¹³⁵

FAS 133 now squarely adopts the mark-to-market approach for symmetry in hedge accounting. By contrast, the tax rules permit mark-to-market or deferral depending on the circumstances, although, in general, the tax rules favor a deferral regime.

In addition, under the tax rules, the realization of the gains and losses from the hedged item generally determine the timing of losses and gains from the hedge. Finally, and more specifically, FAS 133 rejects synthetic accounting. By contrast, the tax rules continue to permit (and, sometimes, require) elaborate integration regimes.

E. What Do These Differences Mean?

FAS 133 adopts the principle that the treatment of derivatives should be uniform. This approach contrasts with the scattered and sometimes confusing approach under the tax rules.

As a result of its "single, comprehensive framework,"¹³⁶ FAS 133 should, in many respects, be easier to apply to derivatives than the tax rules. This

¹³¹For dealers in noncommodity derivatives, it is very difficult to exclude derivative contracts. See section 475(b)(4); Treas. reg. section 1.475(b)-1(c).

¹³²See *Malat v. Riddell*, 383 U.S. 569 (1966).

¹³³See FAS 133, para. 230.

¹³⁴Financial Accounting Standards Bd., *Hedge Accounting: An Exploratory Study of the Underlying Issues* 8-9 (1991).

¹³⁵*Id.*

¹³⁶FAS 133, para. 242.

framework is based on the characteristics of an instrument and generally provides that any instrument that satisfies three defined characteristics should be treated the same.¹³⁷ This uniform standard replaces a series of standards that prescribed different treatment depending on the characterization of the instrument.¹³⁸ This new approach should reduce, if not eliminate, the difficult, and expensive, classification questions that existed under the prior standards.¹³⁹

The accounting rules also should be more transparent to financial statement users. FAS 133 "increases the visibility, comparability, and understandability of the risks associated with derivatives" through its reporting and valuation requirements.¹⁴⁰ Under the prior system, only some derivatives were recognized in financial statements. Of those derivatives, only some realized and unrealized gains and losses were recognized currently. This inconsistency made it difficult for users of financial statements to determine accurately a reporting entity's exposure and benefits from its derivative activities.¹⁴¹ FAS 133 imposes greater reporting requirements and makes consistent the reporting requirements for different instruments. Users of financial statements should be provided with a clearer understanding of a company's derivatives and hedging activity.

By contrast, the tax rules will remain difficult to apply. Although some steps have been taken to provide uniform treatment for similar instruments, the tax rules continue to apply different rules to different forms of financial instruments.¹⁴² The different rules may provide inconsistent treatment for economically similar instruments. These differences in outcome, in turn, elevate the importance of basic classification questions. Thus, companies will likely expend far more effort and resources in properly labeling and identifying financial instruments for tax purposes than will be required for reporting purposes under FAS 133.

In many instances, the tax rules also remain less transparent to users, such as the IRS. To review tax returns, the IRS must educate its agents on the distinctions in instruments and the corresponding distinctions in treatment. The increased complexity resulting

from the lack of a uniform standard increases the amount of effort necessary to perform these functions and the likelihood of disagreements with taxpayers over particular items. The result is increased costs in administering these rules and increased costs of compliance.¹⁴³

Moreover, FAS 133 adopts the principle that derivatives should be marked to market regardless of the holder of the contract. Under this approach, all derivatives subject to FAS 133 are carried at fair value, and are generally marked to market through earnings. The tax rules for derivatives only partially embrace a mark-to-market approach.

As a practical matter, the differences between the full mark-to-market approach for derivatives of FAS 133 and the disjointed approach of the tax rules will challenge companies. Companies often attempt to achieve financial and tax accounting conformity. This so-called "book-tax conformity" generally eases administrative burdens on taxpayers, and reduces the effort necessary to keep records, measure income, and file reports to the government. However, because FAS 133 requires a mark to fair value of all derivatives, companies generally will not be able to conform tax to book accounting. This lack of conformity will increase administrative costs for companies, create planning opportunities for the savvy and well advised, and raise new traps for the unwary.

In addition, companies are likely to face new and significant systems issues for their derivatives. These problems will create a need to carry derivatives at two different amounts, one for accounting purposes and one for tax purposes. Additionally, companies will have to maintain different records and different measuring standards for accounting and tax purposes. Likewise, companies will face substantial difficulties with hedges under FAS 133 and the tax rules. As discussed above, companies may treat certain transactions as hedges for FAS 133, but not for the tax rules, or vice versa. In addition, many companies will need to apply dual timing regimes.

From the perspective of the IRS, accounting and tax differences will exacerbate enforcement efforts. That is because, in many instances, the IRS will not be able to use financial reporting to monitor compliance with the tax rules.¹⁴⁴ Thus, as accounting and tax rules depart,

¹³⁷As previously discussed, however, FAS 133 carves out numerous exceptions to the general rule. These exceptions admittedly erode some of the intended benefits from uniformity.

¹³⁸See FAS 133, paras. 236, 239-242.

¹³⁹There remains a difference between instruments that are derivatives and those that are not. The importance of this distinction is likely to diminish over time as the FASB, consistent with their fundamental decisions, expands the mark-to-market regime to other financial instruments. See FAS 133, para. 3(b).

¹⁴⁰FAS 133, para. 238.

¹⁴¹See FAS 133, para. 234.

¹⁴²Cf. David S. Miller, "Taxpayer's Ability to Avoid Tax Ownership: Current Law and Future Prospects," 51 *Tax Law.* 279, 281 (discussing the five separate provisions enacted in 1997 to address constructive ownership issues for different forms of financial instruments).

¹⁴³The tax rules arguably also produce a more distorted measurement of income as a result of the complex and different approaches to taxing income from different derivative instruments.

¹⁴⁴Taxpayer groups also have noted the value of financial reporting as a tool to reduce audit costs to the IRS and minimize disruptions to taxpayers. See Letter from Michael A. Casciato, President, Wall Street Tax Association, to Donald C. Lubick, then-Acting Assistant Secretary (Tax Policy), United States Department of Treasury, et al., at 4, *Doc 97-24950 (5 pages)*, 97 *TNT* 171-46 (Aug. 15, 1997) (recommending that the IRS audit mark-to-market dealers by comparing the valuations that a dealer uses for tax purposes with those used for such non-tax purposes as risk management, regulatory, financial reporting, and compensation purposes; these comparisons offer a "rich source" of independent confirmation).

accounting information will be less valuable to the IRS. Moreover, planning opportunities, and creative financial engineering, will persist under the tax rules.

V. Next Steps

As noted earlier, FASB plans to pursue "the Board's vision of having all financial instruments measured at fair value in the statement of financial position."¹⁴⁵ Likewise, many tax commentators recommend that the tax rules adopt a broad and uniform mark-to-market method of accounting for financial instruments.¹⁴⁶ Thus, additional steps toward a uniform application of a mark-to-market regime can be expected both for accounting and for tax.

A broader application of mark-to-market might reduce the amount of resources that are dedicated to sorting out the taxation of derivatives.

In tax, Congress has expanded the scope of the mark-to-market approach for derivatives in the last two decades. In general, Congress has applied the mark-to-market approach in circumstances in which taxpayers already were valuing their derivatives for financial reporting or other purposes at least annually. FAS 133 now widens the application of mark-to-market to derivatives for accounting purposes for reporting entities. As a result, the tax rules may now be pushed further to apply a mark-to-market system for derivatives for these taxpayers.

An expansion of mark-to-market for taxpayers that are subject to the new reporting requirements of FAS 133 would add relatively little administrative burden on these taxpayers. It could also alleviate the audit burden of these taxpayers by the IRS, permitting the IRS to rely more heavily on financial reporting to check the accuracy of tax reporting. In addition, a broader application of mark-to-market might reduce the amount of resources (of both taxpayers and the IRS) that are dedicated to sorting out the taxation of deriva-

tives, an enterprise that has been demanding increasing amounts of effort in recent years.

More narrowly, for hedges, additional changes now appear warranted. When the IRS originally proposed the hedging rules, the IRS anticipated that "the hedge accounting methods employed by most taxpayers for financial accounting purposes will satisfy the clear reflection standard . . . because financial accounting attempts to match related items of income and expense."¹⁴⁷ The IRS also noted that "financial accounting standards for hedges are in a state of development. Thus, the proposed regulations do not make the taxpayer's treatment of its hedges for financial accounting purposes determinative for tax purposes."¹⁴⁸ Now that the financial accounting rules have been finalized, a revisit of the tax hedge rules is appropriate. In particular, the IRS should consider permitting taxpayers to identify and mark their hedged items when these items are also marked for financial accounting purposes.

VI. Conclusion

Establishing a coherent regime for the treatment of derivatives is no small task. Unlike direct interests in property, derivatives are contracts. The terms of derivative contracts are limited only by computers and imagination. They can be used for a variety of hedging, investment, and speculative functions. Their values can fluctuate greatly from negative to positive. They can be custom-tailored contracts or exchange-traded contracts. They can require large contingent payments. They are changing constantly. All of these factors complicate any attempt to measure the income and track the carrying value of a derivative contract. FAS 133 and tax present two different approaches to timing the gains and losses from derivatives.

Until the accounting and tax rules are coordinated, FAS 133 and tax will be divergent systems that give rise to numerous book-tax differences. These differences will create systems issues and procedural issues for companies. They will also make the administration of the tax law more difficult. In light of these issues, it may be time to consider additional steps to give companies the ability to conform book and tax.

¹⁴⁵FAS 133, para. 216.

¹⁴⁶See, e.g., Daniel Halperin, "Saving the Income Tax: An Agenda For Research," *Tax Notes*, Nov. 24, 1997, p. 967; Alvin C. Warren, Jr., "Commentary: Financial Contract Innovation and Income Tax Policy," 107 *Harv. L. Rev.* 460 (1993).

¹⁴⁷FI-54-93, 1993-2 C.B. 615, 616.

¹⁴⁸*Id.*