

Interest Rate Hedging in a Volatile Market

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Taxpayers routinely enter into interest rate swaps to manage interest rate risk on their debt issuances. These interest rate swaps are subject to special tax-hedging rules intended to clearly reflect income by matching the recognition of gain or loss on the hedging transaction with the recognition of income, deduction, gain, or loss on the hedged debt instrument.

Although applying this matching principle is intuitive in many situations, applying the tax-hedging rules to transactions in which either the hedging transaction (*i.e.*, the interest rate swap) or the hedged item (*i.e.*, the debt instrument) is terminated early or modified is often challenging and may lead to unclear results. These challenges are not new; however, the current interest rate environment has resulted in large gains or losses on interest rate swaps, which magnifies certain issues. This article revisits the challenges and highlights the uncertainties that arise when applying the matching principle of the tax-hedging rules to common situations in which either the debt instrument or the interest rate swap is modified or terminated.¹

I. Background on Interest Rate Swaps

Before diving into the technical tax rules, it is helpful to understand the basic nomenclature and economics associated with interest rate swaps used to hedge interest rate risk on borrowings.

A transaction in which a company issues floating rate debt and enters into a pay fixed/receive floating interest rate swap to “fix” the interest rate (effectively creating a synthetic fixed rate debt instrument) is an example of a “cash flow hedge.”² Alternatively, a transaction in which a company issues fixed rate debt and enters into a pay floating/receive fixed interest rate swap (effectively creating a synthetic floating rate debt instrument) is an example of a “fair value hedge.”³

Interest rate swap values fluctuate as interest rates increase or decrease. In years with flat or declining interest rates (*e.g.*, in the decade or so prior to 2022), cash flow hedges often had built-in losses. The rapid increase in interest rates over the past year caused many cash flow hedges to appreciate significantly. For

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example, consider a cash flow hedge where the taxpayer agrees to pay 2% fixed in exchange for six-month USD LIBOR⁴ (at a time when six-month USD LIBOR was lower than 2%). With six-month USD LIBOR rates now exceeding 5%, the taxpayer's cash flow hedge has greatly increased in value (that is, it is "in the money"). The termination of an in-the-money interest rate swap will generally result in a gain in the form of a termination payment. If the swap was a tax-hedging transaction, the gain resulting from the termination payment will be accounted for under the tax-hedging rules, described in more detail below.⁵

II. Tax-Hedging Rules—An Overview

A. General Rules

The tax rules provide special character and method-of-accounting (timing) rules for tax-hedging transactions. Code Sec. 1221(b)(2)(A)⁶ defines a hedging transaction as:

any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily—

- (i) to manage the risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer,⁷
- (ii) to manage the 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,⁸ or
- (iii) to manage such other risks as the Secretary may prescribe in regulations.

The determination of whether a hedging transaction manages the taxpayer's risk is based on a facts-and-circumstances analysis.⁹ Under the hedging regulations, a transaction that, as an economic matter, converts a floating interest rate to a fixed interest rate (*i.e.*, a cash flow hedge) manages risk.¹⁰ A fair value hedge of a debt instrument is likewise considered to manage risk and is eligible for hedging treatment.¹¹ The hedging rules also permit a taxpayer to recycle a hedging transaction.¹² For example, a taxpayer may treat a swap that hedged a prior debt instrument (that was retired) as a hedge of another debt instrument if the swap remains outstanding.

To qualify as a hedging transaction for purposes of Code Sec. 1221(a)(7), the taxpayer must properly identify the

transaction as a hedging transaction on or before the day that the taxpayer acquired, originated, or entered into the transaction.¹³ In addition, the item that is hedged (*i.e.*, the transaction that creates risk) must be identified "substantially contemporaneously with entering into the hedging transaction."¹⁴

B. Character Rules

Gain or loss on a properly identified hedging transaction is ordinary.¹⁵ However, if the taxpayer fails to properly identify the hedging transaction, the special character rules under Code Sec. 1221(a)(7) do not apply, subject to relief for certain failures to identify as the result of inadvertent error.¹⁶ Absent inadvertent error relief, any loss on the hedging transaction may be a capital loss if the underlying asset is otherwise a capital asset in the hands of the taxpayer.¹⁷ Further, if the taxpayer does not properly identify the hedging transaction as such, the regulations provide an anti-abuse rule that treats gain on the hedging transaction as ordinary if the taxpayer has no reasonable grounds for not treating the transaction as a hedging transaction.¹⁸ Therefore, it is important for taxpayers to be aware of the identification requirements and properly identify hedging transactions as such (and reidentify hedging transactions following a deemed reissuance of the hedged debt, as discussed below).

C. Hedge Timing Rules

Reg. §1.446-4 provides special method-of-accounting rules (the "Hedge Timing Rules") for tax-hedging transactions. The Hedge Timing Rules apply to hedging transactions as defined in Reg. §1.1221-2(b), regardless of whether the hedge was properly identified as such,¹⁹ and provide that a taxpayer's method of accounting 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 or items being hedged. More than one method of accounting may satisfy the clear-reflection requirement; taxpayers therefore have some flexibility in adopting a method of accounting for a particular type of hedging transaction, so long as their chosen method clearly reflects income.²⁰

The clear reflection of income standard and matching rule are the north star of the Hedge Timing Rules, but their application is not always entirely clear. The Hedge Timing Rules provide specific rules for hedges of certain

categories of hedging transactions (including hedges of inventory purchases and sales and hedges of debt instruments)²¹; however, even if a specific rule applies, the taxpayer's method must clearly reflect income by meeting the matching standard.²² Reg. §1.446-4(e)(4) provides that “[g]ain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by a taxpayer, must be accounted for by reference to the terms of the debt instrument and over the period or periods to which the hedge relates.” The regulations further provide that such gain or loss is generally accounted for under constant yield principles, assuming a fixed rate or qualified floating rate debt instrument remains outstanding.²³

The Hedge Timing Rules provide that the rules of Reg. §1.446-3 generally apply to notional principal contracts used as hedging transactions unless the application of those rules would not result in the matching necessary to satisfy the clear reflection of income requirement.²⁴ A “notional principal contract” refers to 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. Interest rate swaps, floors, and caps generally qualify as notional principal contracts for tax purposes if they provide for periodic payments.²⁵ If a notional principal contract hedges a debt instrument, the method of accounting for periodic payments described in Reg. §1.446-3(e) (ratable daily portions of the periodic payments) and the methods for accounting for nonperiodic payments described in Reg. §1.446-3(f)(2)(ii) and (iv) (amortization over the term of the notional principal contract) would generally clearly reflect the taxpayer's income.²⁶ In relevant part, the Hedge Timing Rules allow the “level payment method” to apply for certain nonperiodic payments.²⁷

The clear reflection of income standard and the matching rule are relatively simple to administer for a taxpayer that enters into an “at-the-market” interest rate swap on the same day that it issues the debt. This is the most common situation for hedges of floating rate debt (at least for taxpayers hedging a specific borrowing); payments on the interest rate swap will generally tie to payments on the debt instrument and the notional amount of the swap will generally be the same as the principal amount of the debt instrument. In this case, the taxpayer simply takes into account the

daily portions of the periodic payments. Several issues may arise when the interest rate swap or the hedged debt is terminated early.

III. Disposition of Hedged Items—Retirement (or Deemed Retirement) of a Hedged Debt Instrument

In the case of a disposition of the hedged asset or liability, Reg. §1.446-4(e)(6) requires the taxpayer to “appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item.” To achieve the required matching, the regulations provide that a taxpayer *may* mark the hedge to market on the date it disposes of the hedged item.²⁸ But, the regulations do not define what constitutes a disposition or termination of a hedged item (for example, is a refinancing treated as a termination or disposition?) or how the matching requirement is satisfied if either there is no gain or loss on the hedged item or any gain or loss on the hedged item is driven by something other than the hedged risk. The Internal Revenue Service (the “IRS”) has not provided any additional guidance on how to satisfy the clear reflection of income requirement when a hedged item is disposed of or terminated (but the hedging transaction remains outstanding). As discussed further below, the lack of clear guidance creates uncertainty as to how to treat certain debt transactions.

A. What Is the Hedged Item and When Is There a Termination?

When applying the Hedge Timing Rules in the context of interest rate swaps, a threshold question is: what is the hedged item? Is the hedged item(s) (i) the interest payments on a specific borrowing, (ii) the interest payments on a specific borrowing and any refinancings of that borrowing, or (iii) interest rate risk more generally? A taxpayer could broadly identify the hedged item(s) to be a “floating rate interest rate risk associated with taxpayer's ordinary obligations.” By doing so, a taxpayer may be able to conclude that, even upon repayment of one borrowing and the issuance of a new borrowing to a different lender, the hedged item(s) remains outstanding and Reg. §1.446-4(e)(6) is inapplicable upon the repayment. Additionally, as discussed above, the Hedge Timing Rules apply even in the absence of a tax identification statement. Absent a clear identification statement, it may be difficult to ascertain what the hedged item is and whether it has been disposed

of in order to determine whether Reg. §1.446-4(e)(6) applies.²⁹

If a specific debt instrument is a hedged item, and it is identified as such, a repayment of the debt instrument would be a termination of a hedged debt instrument. A “significant modification” of the debt instrument would likely also result in a disposition or termination under Reg. §1.446-4(e)(6). A “significant modification” of a debt instrument generally results in a taxable exchange for purposes of Reg. §1.1001-1, potentially resulting in cancellation of debt (“COD”) income or repurchase premium to the borrower.³⁰ An in-depth discussion of the significant modification regulations is beyond the scope of this article. However, a relatively small change in yield or a deferral of a payment date beyond a specified safe harbor can result in a significant modification and a taxable exchange.³¹ While the application of the significant modification rules under Reg. §1.1001-3 is clear in many circumstances, the application of the Hedge Timing Rules is anything but clear in many cases, as illustrated by the following example.

Example. T issues at par \$200 million of floating rate debt (*e.g.*, the interest rate is the Secured Overnight Financial Rate (SOFR) plus 400 basis points) with a term of seven years in exchange for cash. T enters into a floating-to-fixed swap (a cash flow hedge) to synthetically convert the hedged debt instrument into a debt instrument with a fixed interest rate of 7% for the entire term of the debt. T identifies the hedging transaction as a hedge of that specific \$200 million floating rate debt. Five years into the term of the instrument, T and the lenders agree to increase the interest rate on the instrument by more than 100 basis points to compensate the lenders for agreeing to eliminate certain restrictive covenants. The change in yield is beyond the change-in-yield threshold of Reg. §1.1001-3(e)(2)(ii) and results in a deemed debt-for-debt exchange under the significant modification rules of Reg. §1.1001-3.³² T does not terminate the floating-to-fixed swap. At the time of the significant modification, the floating-to-fixed swap has a built-in gain.

The significant modification and deemed exchange could arguably be treated as a termination of the hedged item under Reg. §1.446-4(e)(6), and the taxpayer would be required to match its “built-in gain

or loss” on the floating-to-fixed swap with the gain or loss on the \$200 million of floating rate debt (the hedged item).³³ This raises the question: if the debt instrument has been repaid (or deemed to be repaid), and therefore the hedged item no longer exists for tax purposes, how should taxpayers appropriately match gain or loss on the hedging transaction (the interest rate swap) with any gain or loss on the hedged item (the debt instrument)?

B. How Do the Hedge Timing Rules Apply in the Context of Cash Flow Hedges?

Applying the matching rule under the Hedge Timing Rules in the context of cash flow hedging transactions can be challenging because the value of floating rate debt instruments that reference a benchmark rate (such as SOFR or LIBOR) generally does not change as market interest rates rise or fall (and as a result, floating rate debt instruments generally do not have built-in gain or loss due to market fluctuations in interest rates).³⁴ For this reason, it is unclear whether marking the swap to market on the retirement of the debt instrument satisfies the matching rules. Because the gain on the interest rate swap likely has no connection to any gain or loss on the debt instrument (*i.e.*, for the borrower, COD income or repurchase premium), there is an argument that marking the swap to market and recognizing the gain currently is inconsistent with the matching rule because it would not match the hedging gain to any gain or loss on the hedged item that is attributable to the hedged interest rate risk.³⁵ Under this argument, taxpayers should not only determine what the hedged item is and whether it has been disposed of or terminated, but should also consider whether any gain or loss on the hedged item is related to the hedged risk (*i.e.*, interest rates).

Revisiting the Example, assume the adjusted issue price of the old debt is equal to the issue price of the new debt, such that no COD income or repurchase premium is realized upon the significant modification.³⁶ If no COD income or repurchase premium is realized on the significant modification, it would appear that marking the swap to market would not satisfy the matching requirements because there is no gain or loss on the hedged item at all. Thus, even though the hedged item would appear to have been terminated, marking the hedging transaction to market, and currently including hedging gain in income when there was no corresponding amount of income, expense, gain, or loss realized on the retirement of

the debt instrument does not appear to clearly reflect income.

If, however, COD income or repurchase premium is realized and recognized on the significant modification, it could be argued that marking the swap to market (and including any gain or loss in income currently) may satisfy the matching rule because there is an item of income or expense to match it against.³⁷ Although this argument has some intuitive appeal, the repurchase premium is commonly driven by changes in T's credit quality (and not changes in the floating interest rates, resulting in changes in the value of the hedging transactions), which once again raises the question of whether marking the swap to market satisfies the matching principle.

If any repurchase premium is realized upon a significant modification, but not immediately recognized, there may be a stronger argument that marking the swap to market does not satisfy the matching requirement. For example, if the issue price of the new debt instrument is determined under Code Sec. 1274 such that any repurchase premium³⁸ would need to be amortized over the term of the newly issued debt instrument in the same manner as if it were the original issue discount ("OID"),³⁹ no immediate loss is recognized on the hedged debt to match to the gain on the swap.

Going back to the Example, assume T issued the debt at 98% (or \$196 million). Further assume that, for simplicity, the adjusted issue price on the date of the significant modification remains \$196 million and the issue price of the new modified debt is \$200 million under Code Sec. 1274, so that the repurchase premium realized is \$4 million (equal to the unamortized OID).⁴⁰ The repurchase premium will be amortized over the term of the new/modified debt instrument. Under this fact pattern, there are at least two arguments for not marking the swap to market: (1) the repurchase premium is not driven by the hedged risk (interest rates), and including the hedging gain in income currently will not offset a corresponding loss recognized on the debt, so marking the swap to market may not satisfy the matching principles; and (2) because the repurchase premium is not immediately recognized and is instead amortized over the life of the new debt under Reg. §1.163-7(c), marking the floating-to-fixed swap to market and recognizing the gain currently would not appear to match the timing of the gain recognition on the swap with the loss (*i.e.*, repurchase premium) on the hedged debt instrument.⁴¹

If the swap was marked to market and the gain was recognized currently, because T continues to hold the

now off-market swap, T would be deemed to make an offsetting payment on the swap that would be treated as a nonperiodic payment. This payment would be taken into account over the remaining life of the swap, presumably under the level payment method.⁴² Thus, with respect to the deemed termination and nonperiodic payments on the swap, T is in the same net position, but there would be a timing mismatch.

Instead of taking the gain on the swap currently, one alternative could be to mark the swap to market but spread the gain over the life of the swap. Because T continues to hold the now off-market swap, it would be deemed to have made an offsetting payment on the swap that would be treated as a nonperiodic payment. The payment would be amortized over the remaining life of the floating-to-fixed swap.⁴³ Although this approach results in T amortizing equal and offsetting amounts over the remaining term of the swap, the two amounts technically could be amortized under different methods of accounting. Gain, as a result of marking the swap to market, would likely be amortized straight line over the term of the old swap or using constant yield principles to match it with the repurchase premium. The upfront payment on the new swap would likely be amortized under the level payment method. It is also reasonable to ask whether this disconnect fails to satisfy the clear reflection of income standard under the Hedge Timing Rules and whether T should instead be able to apply the same method of accounting for both payments. If the same method of accounting was applied to both amounts, the amortization in each period would net to zero, putting T in the same tax position as if the swaps were not marked to market. This result would appear to clearly reflect income.

C. Do the Recycled Hedge Rules Provide Clarity?

Because the hedging transaction remains outstanding, it could hedge other items as a recycled hedge. Reg. §1.446-4(e)(7) provides that if a taxpayer enters into a hedging transaction by recycling a hedge of a *particular* hedged item to serve as a hedge of a *different* item, as described in Reg. §1.1221-2(d)(4),⁴⁴ then the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged item. Gain or loss attributable to the period after the recycling must be matched to the hedged item under the matching principles of Reg. §1.446-4(b). These regulations indicate that if a taxpayer recycles a hedging transaction to hedge another item, it may still have to mark the hedging

transaction to market to appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed hedged item. As noted above, marking the hedging transaction to market may not make sense if the hedged item is a floating rate instrument where the borrower does not realize or recognize COD income or repurchase premium upon its disposition, or any such COD income or repurchase premium is unrelated to fluctuations in interest rates (*i.e.*, the hedged risk). In this situation, the recycled hedge rules do not provide any further clarity.

D. Where Does This Leave Us?

Practically speaking, many taxpayers look to Reg. §1.446-4(e)(6) and mark their hedging transactions any time there has been a disposition or deemed disposition of the hedged item, including *via* a significant modification, regardless of whether COD income or repurchase premium is realized and/or recognized on the debt and whether such COD income or repurchase premium is related to fluctuations in interest rates. Though such an approach may seem reasonable at first glance, it may not actually satisfy the matching rule upon careful consideration of Reg. §1.446-4(e), which requires the taxpayer to “appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item.” Reg. §1.446-4(e)(6) provides merely that a taxpayer *may* mark the hedge to market to meet the matching requirement and does not supersede the matching requirement. Accordingly, additional guidance on applying Reg. §1.446-4(e)(6) in the context of modifications of debt instruments, and of floating rate debt instruments in particular, would be helpful. In the absence of such guidance, taxpayers may wish to include a statement in the tax hedge identification explaining how the hedging transaction will be accounted for upon a disposition or deemed disposition of the hedged item.

IV. Terminations of Hedging Transactions—Early Termination of an Interest Rate Swap

Rather than disposing (or being deemed to dispose) of the hedged item, a taxpayer may instead terminate the hedging transaction while the hedged item remains outstanding. For instance, in the Example above, rather than T and the lenders agreeing to modify the interest rate on the instrument, assume T terminates the floating-to-fixed swap in the fifth year of the arrangement

when the swap has a built-in gain. Upon termination, T will receive a termination payment from the swap counterparty. This raises the question of how T should treat the termination payment for U.S. federal income tax purposes.

As noted above, the Hedge Timing Rules provide that T’s method of accounting for the hedging transaction must clearly reflect income and 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.⁴⁵ Further, the regulations provide additional guidance when stating that the gain or loss from the hedging transaction “must be accounted for by reference to the terms of the debt instrument *and the period or periods to which the hedge relates.*”⁴⁶ The regulations generally provide for this accounting to be done under constant yield principles (assuming a fixed rate or qualified floating rate debt instrument remains outstanding).⁴⁷

In Rev. Rul. 2002-71,⁴⁸ the IRS addressed the early termination of an interest rate swap that hedged a fixed-rate debt instrument. In the ruling, the taxpayer issued a 10-year, fixed-rate debt instrument and entered into a notional principal contract with a term of five years to economically convert the fixed rate into a floating rate during the first five years of the debt instrument (*i.e.*, the taxpayer entered into a fair value hedge). On the last day of the second year, the taxpayer terminated the notional principal contract and made or received a termination payment. The IRS ruled that, to clearly reflect income, the taxpayer was required to take into account the gain or loss from terminating the notional principal contract over the three-year period that was left on the hedging transaction because that was the period to which the hedge related. The ruling explained that “[t]he termination payment made or received by [the taxpayer] represents the present value of the extinguished rights and obligations under the [notional principal contract] for Year 3 through Year 5.”⁴⁹

Applying Reg. §1.446-4(e)(4) and Rev. Rul. 2002-71 to the termination payment in the Example above, the payment would be spread over the remaining two-year term of the interest rate swap. This satisfies the matching requirement because the termination payment reflects the present value of the payments that are expected to be made under the interest rate swap over the next two years, and the payments correspond to the increased interest rate payments that are expected to be made on the floating-rate debt over a such two-year period. Stated another way, the gain resulting from

the termination payment would be matched to T's (expected) increased interest expense deductions over the next two years resulting from the increase in the floating interest rate.

It has been argued, however, that Rev. Rul. 2002-71 should be limited to fair value hedges because, in the context of a cash flow hedge, as noted above, there is likely no gain or loss with respect to the debt that is attributable to market fluctuations in interest rates.⁵⁰ That is, while matching was accomplished in Rev. Rul. 2002-71 by spreading the gain or loss resulting from the termination payment because there was a corresponding unrealized gain or loss in the hedged debt that was attributable to interest rate fluctuations, matching would not necessarily be accomplished when there is no corresponding gain or loss in the hedged debt.⁵¹ Under this reasoning, one could argue that the gain or loss resulting from the termination payment should be recognized currently.⁵²

The IRS has taken the position that the principles underlying Rev. Rul. 2002-71 apply equally to cash flow hedges. Specifically, the IRS followed Rev. Rul. 2002-71's spreading approach in a 2010 Chief Counsel Advice (CCA), taking the position that hedging gain or loss on a cash flow hedge was spread over the term of the floating-rate debt that was hedged.⁵³ The CCA applied Rev. Rul. 2002-71 and quoted the language in Reg. §1.446-4(e)(4) stating that "assuming that a fixed rate or qualified floating rate instrument remains outstanding, hedging gain or loss is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates."

The spreading approach and the current recognition approach highlight the issue of whether gain or loss resulting from a termination payment on a cash flow hedge is better matched with (a) the expected interest rate exposure on the floating rate debt (looking to the remaining term of the interest rate swap, had it not been terminated) or (b) the current value of the floating rate debt at the time of the interest rate swap termination.⁵⁴

The fact that the termination payment is determined by reference to the present value of the expected floating interest rate payments over the remaining term of the swap favors the former approach. One could argue, however, that spreading the termination payment is more appropriate when doing so results in locking in an effective interest rate going forward. While spreading the termination payment related to a hedge of a fixed-rate

debt locks in an effective interest rate on the debt going forward (in a similar manner to an anticipatory hedge of fixed-rate debt), spreading the termination payment related to a hedge of a floating-rate debt does not lock in an effective interest rate because the rate will still be subject to fluctuations. With that said, it is not clear that locking in an effective interest rate is relevant when applying the matching principles in the context of a cash flow hedge.

Companies routinely enter into interest rate swaps to manage interest rate risk exposure on their debt obligations. But, despite the ubiquity of interest rate swaps, there is little clear guidance addressing how common transactions are accounted for under the Hedge Timing Rules.

Given the language in Reg. §1.446-4(e)(4) and the conclusion in Rev. Rul. 2002-71 (and the IRS's application of similar principles in the 2010 CCA), many practitioners continue to spread the gain or loss over the remaining term of the hedging transaction. As with the disposition of a hedged item, taxpayers should consider whether their method for accounting for the termination payment comports with the general matching requirement in the regulations. Further, taxpayers may wish to include a statement in the tax hedge identification for the hedging transaction explaining how any early termination payment will be taken into account to potentially strengthen their position if challenged.

V. Swap Modifications—"Blend-and-Extend" Transactions

If a debt instrument hedged with an interest rate swap is refinanced or modified, the terms of the interest rate swap may no longer mirror those of the debt instrument, resulting in a less effective hedge of interest rate risk as an

economic matter. As a result, a taxpayer may opt to terminate its existing interest rate swap and enter into a new swap with terms that match the terms of the “new” debt instrument. In this case, the taxpayer generally makes or receives a termination payment to terminate the existing swap and enters into a new, at-the-market swap (which generally does not require an upfront payment). (We discussed the tax treatment of termination payments in Section IV, above.)

Moreover, given the recent volatility in interest rates, the lack of clarity has been particularly problematic because many companies hold swaps with significant built-in gains or losses.

To avoid making a large cash termination payment, a taxpayer may prefer to replace the existing swap with a new, off-market swap in what is colloquially referred to as a “blend and extend” transaction.⁵⁵ The new interest rate swap generally has the same term as the taxpayer’s newly issued indebtedness (that is, the term is “extended”), paired with an off-market interest rate (that is, the rate is amended such that the fair market value of the “old” and “new” swap are the same (or roughly the same)).

In a blend-and-extend transaction, the taxpayer has in substance terminated its original swap (and has made (or received) a termination payment) and has entered into a new, off-market swap under which it will make payments at an off-market rate. In exchange for entering into this new swap, the taxpayer is deemed to receive (or make) an upfront payment that, because the two swaps are structured to have the same (or roughly the same) fair market value, will be the same amount as the termination payment on the original swap. The payments are commonly netted so that no net payments are due at the time of contracting.

The lack of a net payment does not, however, simplify the tax analysis. Rather, blend-and-extend transactions raise a number of interesting issues, including (a) whether the changes to the original swap (or the substitution of the original swap for the new swap) result in a taxable termination of

the original swap, and (b) how any income, deduction, gain, or loss is accounted for under the Hedge Timing Rules. Although a blend-and-extend transaction may be an elegant solution from a cash flow perspective (by avoiding a termination payment), the tax analysis is anything but elegant and certainly not easy.

A. Is a Modification of an Interest Rate Swap a Taxable Event?

Determining whether a modification to a derivative gives rise to a Code Sec. 1001 (taxable) event can be challenging given the lack of clearly defined rules. For this reason, before analyzing whether a modification of a derivative (such as an interest rate swap) results in a taxable termination of the original contract for a new contract, it is fair to ask whether this line of analysis is required. As discussed above, if a debt instrument is significantly modified, the Hedge Timing Rules may require an issuer to mark its tax-hedging transaction to market. If so, then regardless of whether the modification to the swap constitutes a Code Sec. 1001 transaction, the taxpayer may be required to tax account for any built-in gain or loss on the swap under the Hedge Timing Rules.

Nonetheless, there is still a universe of transactions for which the “termination or not” determination matters. For example, the modifications made to the debt instrument may not give rise to a significant modification, so the Hedge Timing Rules may not require the hedge to be marked to market,⁵⁶ or (less common) the hedge may be modified despite no corresponding changes to the debt.⁵⁷ So the question remains: how does a taxpayer determine whether changes to a swap constitute a taxable event?

Under Code Sec. 1001, gain or loss is realized upon an “exchange of property for other property differing materially either in kind or in extent.”⁵⁸ Although, as discussed above, there is a defined set of rules to determine whether a modification of a debt instrument results in an instrument that is materially different in kind or extent (and therefore, results in the retirement of the existing debt instrument),⁵⁹ the same is not true for non-debt financial contracts⁶⁰ (such as interest rate swaps⁶¹). The proper application of Code Sec. 1001 to non-debt financial transactions is the subject of a number of thoughtful articles.⁶² This article does not attempt to resolve the issue but instead offers an overview of how the analysis might be applied to add context to this uncertain area.

Practitioners often look to whether a change to a financial contract represents a “fundamental change” to the contract. This theory is based on Rev. Rul. 90-109,⁶³ which addresses whether the exercise of an option to change the insured person covered by a life insurance policy constitutes a sale or disposition of the policy under Code Sec. 1001. In concluding that it was, the IRS described the relevant standard as follows:

A change in contractual terms effected through an option provided in the original contract is treated as an exchange under section 1001 if there is a sufficiently fundamental or material change that the substance of the original contract is altered through the exercise of the option. Under such circumstances, the old contract is treated as if it were actually exchanged for a new one.⁶⁴

However, Rev. Rul. 90-109 involved a fact pattern in which the change was made pursuant to the exercise of an option in the contract. It is unclear whether the standard adopted in the ruling should be applied to different fact patterns or whether some other approach is more appropriate in analyzing whether the pre- and post-modification swap “differ materially in kind or extent.” Because interest rate swaps share many similarities with debt, applying the principles of Reg. §1.1001-3(e) would seem to be a reasonable and administrable approach in many instances (particularly in the context of debt instrument hedges).⁶⁵ It may also be argued that the rules of Reg. §1.446-3 provide guidance on what changes to the terms of a notional principal contract are permissible while maintaining the same contract for U.S. tax purposes,⁶⁶ such that a change that is contemplated by the rules arguably should not result in a taxable event under Code Sec. 1001. Nonetheless, given the absence of comprehensive guidance addressing modifications of interest rate derivatives, taxpayers and practitioners still face uncertainty when determining the appropriate standard for applying Code Sec. 1001.⁶⁷

B. Tax Accounting for Blend-and-Extend Transactions

Let us assume that the taxpayer has gain or loss on an interest rate swap that must be accounted for under the Hedge Timing Rules.⁶⁸ As discussed above, no payment is generally made in most blend-and-extend transactions. Instead, the termination payment due on the “old” swap and the upfront payment on the “new”

swap are netted. Although no net payment is made, it seems clear that the extinguishment (or mark to market) of the old swap and entering into the new swap are both transactions with tax significance.⁶⁹

1. Termination of Existing Swap

Assuming the blend-and-extend transaction results in the realization of gain or loss on termination of the existing swap, the resulting termination payment would be tax accounted for in the same manner as any other termination payment on an interest rate swap.⁷⁰ Recall, the Hedge Timing Rules require taxpayers to match gain or loss on termination (or deemed termination) of a tax-hedging transaction with income, deduction, gain or loss on the hedged debt instrument.⁷¹ As a result, if there is a taxable exchange with respect to the hedged debt instrument as well, the matching rule could be interpreted to require the current recognition of gain or loss on termination of the hedging transaction. If the taxable exchange of the hedged debt instrument results in the current recognition of repurchase premium or COD income, current recognition of any gain or loss on termination of the swap may satisfy the matching requirement under the Hedge Timing Rules. As noted above, it could also be argued that such repurchase premium or COD income is unrelated to interest rate fluctuations (*i.e.*, the hedged risk) such that the gain or loss on the termination of the swap should not be recognized currently.

Upon a repayment or refinancing of the hedged debt, or a termination of the swap, the company will need to consider any gain or loss realized and whether the company’s method of recognizing any such gain or loss truly comports with the matching requirement.

If any modification of the hedged debt instrument did not result in a significant modification, as discussed above, there is a question as to whether the termination payment should be recognized currently or amortized. A similar issue arises in situations where the original

debt instrument is deemed to be retired in a significant modification, but either such modification did not give rise to COD income or repurchase premium, or the modification gave rise to repurchase premium that must be amortized over the term of the “new” debt. In either situation, because no amounts are included in income currently with respect to the hedged debt instrument, the clear reflection of income (matching) principle underlying the Hedge Timing Rules appears to support amortization of the termination payment (and not currently including it in income). This begs the question: over what period would the termination payment be amortized (and under what method of accounting)? Although the guidance discussed above would suggest that the termination payment should be amortized over the remaining term of the swap,⁷² it is not clear that doing so results in a clear reflection of income in all cases. For example, if the term of the “new” debt is the term over which the tax attributes of the old debt are being amortized, it is fair to ask if a clear reflection of income is better achieved by amortizing the termination payment over the term of the new debt (and swap, which will generally match the term of the new debt).

In any event, as set forth above, Reg. §1.446-4(e)(4) suggests that a termination payment should be accounted for as an adjustment to the yield of the debt instrument (*i.e.*, under a constant yield to maturity) when the hedged debt instrument remains outstanding. Rev. Rul. 2002-71 follows this approach in the case of the termination payment on a fair value hedge. Amortizing the termination payment under a constant yield method in this instance appears to be consistent with the clear-reflection standard under the Hedge Timing Rules, although amortization of the termination payment straight line may also be reasonable.

2. Upfront Payment on New Swap

Assuming the payment is not subject to special rules applicable to “significant nonperiodic payments,”⁷³ the payment will generally be amortized over the term of the contract under the level payment method.

As discussed above, if a termination payment (on the existing swap) is required to be amortized (and not

currently included in income), the amortization would generally be under a constant yield or straight-line method. The upfront payment on a swap is generally amortized under the level payment method. Moreover, very technically, the termination payment may be amortized over the remaining term of the old swap while the upfront payment on the new swap will be amortized over the term of the new swap (*i.e.*, over a longer period of time). As a result, while these two amounts are equal, the income and deduction for the amortization of these amounts may not be equal and offsetting in any period. This distinction may catch some taxpayers by surprise. As noted above, it is also not clear that applying the Hedge Timing Rules in a manner that results in equal and offsetting amounts being amortized over different periods of time (and potentially using different amortization methods) clearly reflects income or whether an approach that matches the timing and amount of the amortization of the termination and upfront payments would more clearly reflect income. It may be challenging to find support under existing law for the latter position (beyond the general clear-reflection standard mandated by the Hedge Timing Rules).

VI. Conclusion

Companies routinely enter into interest rate swaps to manage interest rate risk exposure on their debt obligations. But, despite the ubiquity of interest rate swaps, there is little clear guidance addressing how common transactions are accounted for under the Hedge Timing Rules. Moreover, given the recent volatility in interest rates, the lack of clarity has been particularly problematic because many companies hold swaps with significant built-in gains or losses. Upon a repayment or refinancing of the hedged debt, or a termination of the swap, the company will need to consider any gain or loss realized and whether the company’s method of recognizing any such gain or loss truly comports with the matching requirement. In many cases, these transactions will require taxpayers to navigate gray areas in attempting to apply the Hedge Timing Rules to their transactions, at least until additional guidance is published.

ENDNOTES

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- ¹ While this article is intended to add to the discussion, it is by no means the first to address the Hedge Timing Rules and hedging transactions more generally. Rather, we believe these issues are worth revisiting because today's interest rate environment is likely to result in these situations occurring more frequently. See, e.g., David C. Garlock & Alan B. Munro, *The Timing of Interest Rate Hedging Gains and Losses*, 20 J. TAX'N OF INVESTS. 195 (2003) (herein referred to as the "Garlock and Munro Article"); and William R. Pomierski, *Interest Rate Hedging in a Rising Market: A Primer for Borrowers*, 13 J. TAX'N FIN. PRODUCTS 39 (2015).
- ² This article uses the term "synthetic" in a pure economic sense, to describe the resulting instrument as an economic matter. That is, this article focuses on hedging transactions under Code Sec. 1221 and generally does not address "synthetic debt instruments" within the meaning of Reg. §1.1275-6(b)(4).
- ³ The terms "cash flow hedge" and "fair value hedge" are used in generally accepted accounting principles (GAAP) nomenclature. See generally FASB Accounting Standards Codification Topic 815, Derivatives and Hedging; FASB Accounting Standards Codification Topic 815, Fair Value Hedging. A cash flow hedge manages variability in future cash flows. A fair value hedge manages exposure to changes in the fair value of the asset or liability.
- ⁴ LIBOR is an acronym for London Interbank Offered Rate, a floating interest rate index (USD LIBOR expected to cease publication in 2023).
- ⁵ We note that similar issues arise with interest caps (or floors) as well. This article focuses on interest rate swaps.
- ⁶ Unless otherwise indicated all "Code Sec." or "Reg. §" references are with respect to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury Regulations promulgated thereunder.
- ⁷ Property is considered "ordinary property" for this purpose if a sale or exchange of the property would result in ordinary gain or loss for the taxpayer and would not, under any circumstances, produce capital gain or loss for the taxpayer. Reg. §1.1221-2(c)(2).
- ⁸ An obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce capital gain or loss. Reg. §1.1221-2(c)(2).
- ⁹ Reg. §1.1221-2(c)(4)(i). The purchase or sale of a debt instrument, an equity security, or an annuity

contract is not considered a hedging transaction that is entered into primarily to manage risk for this purpose. Reg. §1.1221-2(d)(5).

- ¹⁰ Reg. §1.1221-2(d)(2).
- ¹¹ *Id.*
- ¹² Reg. §1.1221-2(d)(4).
- ¹³ Reg. §1.1221-2(f)(1). The specific identification requirements for various hedging transactions are set forth in detail in Reg. §1.1221-2(f). A hedge designation for financial accounting purposes does not satisfy the identification requirement, unless the designation includes language specifically identifying the transaction as a hedge for U.S. federal income tax purposes. Reg. §1.1221-2(f)(4)(ii).
- ¹⁴ Reg. §1.1221-2(f)(2)(i). An identification of the hedged item that is more than 35 days after the hedging transaction was entered into is not considered substantially contemporaneous for this purpose. Reg. §1.1221-2(f)(2)(ii).
- ¹⁵ Code Sec. 1221(a)(7) provides that the term "capital asset" does not include a hedging transaction that is clearly identified on or before the day that it is entered into.
- ¹⁶ Reg. §1.1221-2(g)(2)(i). Specifically, Reg. §1.1221-2(g)(2)(ii) provides that if the taxpayer does not meet the identification requirements, the taxpayer may treat the gain or loss from the transaction as ordinary income or loss subject to the following conditions:
 - 1) The transaction is a hedging transaction as described in Reg. §1.1221-2(b);
 - 2) The failure to identify the transaction was due to inadvertent error; and
 - 3) All of the taxpayer's hedging transactions in all open years are treated on either original or, if necessary, amended returns as provided in Reg. §§1.1221-2(a)(1) and (2).
- ¹⁷ An interest rate swap that references LIBOR or SOFR can present a difficult question regarding the nature of the underlying asset as capital or ordinary (and thus whether a payment to terminate the swap results in a capital gain or loss). See Code Sec. 1234A(1); Proposed Reg. §1.1234A-1. A full discussion of the character issue is outside of the scope of this article.
- ¹⁸ Reg. §1.1221-2(g)(2)(iii).
- ¹⁹ See Reg. §1.446-4(a):

[A] hedging transaction as defined in section 1.1221-2(b) (whether or not the character of gain or loss from the transaction is determined under section 1.1221-2) must be accounted for under the rules of this section. To the extent that provisions of any other regulations governing the timing of income, deductions, gain, or loss are inconsistent with the rules of this section, the rules of this section control.

See also Rev. Rul. 2003-127, 2003-2 CB 1245, where the IRS rules that:

If a transaction satisfies the definitions of a hedging transaction in §1221(b)(2) (A) and §1.1221-2(b), the taxpayer must account for the transaction using a method

of accounting that is permissible under §1.446-4, even if the taxpayer fails to identify the transaction under §§1.1221-2(f) and 1.446-4(d)(2).

Note that the Revenue Ruling did not address a Code Sec. 1256 contract. It is unclear whether the Hedge Timing Rules also takes precedence over statutory timing rules (such as Code Sec. 1092 or 1256). Despite the requirement that a taxpayer's method of accounting must clearly reflect income (and applying Code Secs. 1092 or 1256, for example, may not clearly reflect income), IRS informal guidance has suggested a slightly narrow interpretation of Reg. §1.446-4(a) in the context of certain unidentified hedging transactions. See, e.g., CCA 201034018 (April 20, 2010). For an opposing viewpoint, see Michael (Wel-Chin) Mou & David H. Shapiro, *Does Section 1256 Incorporate an Inadvertent Error Exception?*, 128 TAX NOTES 1159 (September 13, 2010).

- ²⁰ Reg. §1.446-4(c). Once a method of accounting is adopted, that method must be applied consistently and can only be changed with consent of the Commissioner. Reg. §1.446-4(c). Taxpayers are also required to maintain books and records describing the method of accounting used for each type of hedging transaction and how the clear reflection requirement is satisfied. Reg. §1.446-4(d). There is, however, no explicit penalty for failing to keep such books and records.
- ²¹ Reg. §1.446-4(e).
- ²² *Id.*
- ²³ Reg. §1.446-4(e)(4).
- ²⁴ Reg. §1.446-4(e)(5).
- ²⁵ Reg. §1.446-3(c)(1)(i). Futures, forwards, and options are not notional principal contracts. Reg. §1.446-3(c)(1)(ii).
- ²⁶ Reg. §1.446-4(e)(5). Periodic payments are payments made or received under a notional principal contract that are payable at intervals of one year or less during the term of the contract. Taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of periodic payment for the taxable year to which that portion relates. Reg. §1.446-3(e)(1), (2). Nonperiodic payments are payments that are not periodic payments or termination payments (a payment made or received to extinguish or assign the remaining rights and obligations under the notional principal contract). Reg. §1.446-3(f)(1).
- ²⁷ Reg. §1.446-3(f)(2)(iii)(A). The regulations describe the level payment method as follows:

An upfront payment on a swap may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap contract (the level payment method), adjusted as appropriate to take account of increases or decreases in the notional principal amount. The discount rate used in this calculation must be the rate (or rates) used by the parties to determine the amount of the nonperiodic payment. If that rate

is not readily ascertainable, the discount rate used must be a rate that is reasonable under the circumstances. Under this method, an upfront payment is allocated by dividing each equal payment into its principal recovery and time value components. The principal recovery components of the equal payments are treated as periodic payments that are deemed to be made on each of the dates that the swap contract provides for periodic payments by the payor of the nonperiodic payment or, if none, on each of the dates that the swap contract provides for periodic payments by the recipient of the nonperiodic payment. The time value component is needed to compute the amortization of the nonperiodic payment, but is otherwise disregarded.

Id.

- ²⁸ Additionally, if the taxpayer intends to dispose of the hedging transaction within a reasonable period (generally within seven days), it may be appropriate for the taxpayer to match the realized gain or loss on the hedge with the gain or loss on the disposed item. Reg. §1.446-4(e)(6). If the taxpayer intends to dispose of the hedging transaction within a reasonable period and the hedge is not actually disposed of within such period, the taxpayer must match the gain or loss on the hedge at the end of the period with the gain or loss on the disposed item. *Id.*
- ²⁹ In the absence of an identification, in some cases it may also be reasonable to conclude that the hedging transaction relates to interest rate risk generally (and not to a specific debt instrument), because no specific debt instrument was identified. It is unclear whether a GAAP identification of the hedge as specific to a particular debt instrument may put pressure on such a position.
- ³⁰ Reg. §1.1001-3(b). See also Reg. §1.61-12(c)(2)(i) (indicating that a repurchase includes a Code Sec. 1001 exchange).
- ³¹ See Reg. §1.1001-3(e) for the rules determining whether a modification is a significant modification. Reg. §1.1001-3(c) defines what constitutes a modification.
- ³² Reg. §1.1001-3(e)(2)(ii) provides that a change in yield is a significant modification if the yield on the modified instrument varies from the annual yield on the unmodified yield by more than the greater of (a) 25 basis points or (b) $0.05 \times$ annual yield.
- ³³ For purposes of this initial example, we are assuming that the hedge identification completed by the taxpayer for U.S. federal income tax purposes did not reference any refinancings of the debt or future floating-rate debt issuances.
- ³⁴ That is not to say that a floating rate debt instrument could never fall in value. For example, if the borrower's creditworthiness declines, a floating rate instrument will likely decline in value. Moreover, credit spreads in the market may change over time, impacting the value of the debt.

³⁵ See, e.g., TAM 201135030 (May 27, 2011) (rejecting the taxpayer's argument that unamortized hedge gain from an anticipatory interest rate hedge could be deferred when the taxpayer made an election under Code Sec. 108(i) to defer COD income realized on the retirement of the hedged debt because (i) there was no connection between the hedge gain and the COD income to require matching and (ii) the COD income did not relate to changes in interest rates).

³⁶ The adjusted issue price of a debt instrument is the issue price of the debt instrument (i) increased by the amount of original issue discount previously includible in the gross income of any holder (determined without regard to Code Secs. 1272(a)(7) and 1272(c)(1)); and (ii) decreased by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest. Reg. §1.1275-1(b). A debt instrument's issue price is determined under the rules of Code Secs. 1273 and 1274 and the regulations issued thereunder. See Reg. §§1.1273-2 and 1.1274-2. If a substantial amount of the debt instruments within a single issue are issued for cash, then the debt instrument will have a cash issue price. Reg. §1.1273-2(a). If an issuer of debt is unable to establish the debt instrument's issue price under the cash issue price rules of Reg. §1.1273-2(a) and the debt constitutes publicly traded debt (i.e., debt traded on an established market) or is issued for publicly traded property, the issue price is generally the debt instrument's fair market value or the property's fair market value on the issuance date. Reg. §1.1273-2(b) and (c). If the issue price of a debt instrument is not determined under Reg. §1.1273-2(a), (b), or (c), then the issue price of the debt instrument is generally determined Code Sec. 1274, which provides that the issue price of the debt instrument is its stated principal amount if there is adequate stated interest.

³⁷ In our example, assume that on the date of the significant modification, the debt is publicly traded within the meaning of Reg. §1.1273-2(a) and was trading at 101% (of its face amount), such that the new debt has an issue price of \$202 million. Because the original debt was issued at par, T has \$2 million of deductible repurchase premium. T would recognize the repurchase premium currently. Reg. §1.163-7(c).

³⁸ The issue price of a debt instrument under Code Sec. 1274 is generally the stated principal amount, so the repurchase premium would essentially be any unamortized OID.

³⁹ Reg. §1.163-7(c) provides that if the issue price of the newly issued debt instrument is determined under either Code Sec. 1273(b)(4) or 1274, any repurchase premium is not deductible in the year of the repurchase but is amortized over the term of the newly issued debt instrument in the same manner as if it were OID. In practice, this means that if the issue price of the new debt instrument is not a cash issue price pursuant to Reg. §1.1273-2(a) or a fair market value issue price pursuant to Reg. §1.1273-2(b) or (c), then

the repurchase premium is not immediately deductible and must be amortized over the new instrument as if it were OID, generally on a constant yield to maturity method.

⁴⁰ OID is the difference between a debt instrument's stated redemption price at maturity and its issue price. Reg. §1.1273-1(a). See note 36 regarding how issue price is determined. The stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments. Reg. §1.1273-1(b). Qualified stated interest is stated interest that is unconditionally payable in cash or in property (other than debt instruments of the issuer) at least annually at a single fixed rate. Reg. §1.1273-1(c).

⁴¹ If, instead, the repurchase premium is not immediately recognized because it is subject to deferral under Code Sec. 163(j), query whether there would be a similar argument that the swap should not be marked to market. In this respect, TAM 201135030 (May 27, 2011) may be informative, which provided unamortized hedge gain from an anticipatory interest rate hedge could not be deferred when the taxpayer made an election under Code Sec. 108(i) to defer COD income realized on the retirement of the hedged debt. TAM 201135030 (May 27, 2011).

⁴² Reg. §1.446-3(f)(2).

⁴³ Reg. §1.446-3(f)(2). Note that the example assumes that the old and new debt instruments have the same maturity date.

⁴⁴ Reg. §1.1221-2(d)(4) provides that a taxpayer may enter into a hedging transaction by using a position that was a hedge of one asset or liability as a hedge of another asset or liability. The definition of "hedging transaction" applies anew at the time of a recycling, as though the position were entered into at that time. Accordingly, the hedging transaction must satisfy the requirements above, including the identification requirement.

⁴⁵ Reg. §1.446-4(b).

⁴⁶ Reg. §1.446-4(e)(4) (emphasis added).

⁴⁷ Reg. §1.446-4(e)(4).

⁴⁸ 2002-2 CB 763.

⁴⁹ Rev. Rul. 2002-71, 2002-2 CB 763.

⁵⁰ See Garlock and Munro Article.

⁵¹ This argument also raises the issue of how to measure gain or loss in the hedged debt instrument. That is, is gain or loss measured by simply looking to the current fair market value of the debt, or is it necessary to take into account the issue price of the debt upon a hypothetical deemed reissuance?

⁵² See Garlock and Munro Article, which states:

[W]hen a taxpayer terminates a floating-to-fixed swap that is subject to the general hedge timing rules of Reg. §1.446-4, the gain or loss ought to be recognized in the year of the termination, not spread over the remaining life of the debt or swap. This would conform the timing results of the retirement of an actual fixed-rate debt, the deemed retirement of a synthetic fixed-rate debt instrument under

Reg. §1.1275-6, and a swap termination under Reg. §1.446-4(e)(4).

The Garlock and Munro Article argues that looking to the integrated transaction rules in Reg. §1.1275-6 supports the current recognition of the hedge gain or loss. Taking the original example above, if T elected to integrate the floating-rate debt obligation and the interest rate swap, it would be treated as the borrower on a single fixed-rate debt obligation. If T then terminated the interest rate swap and legged out of the integrated transaction, under the integrated transaction rules, T generally would be required to currently recognize COD income to the extent that the swap is in the money. See Reg. §1.1275-6(d)(2)(ii)(B). As a result, currently recognizing gain or loss from the early termination of a cash flow hedge would conform the timing results to that of a taxpayer that makes an integrated transaction election. The integrated transaction rules, however, are set forth in an elective regime that would provide for the creation of a single fixed-rate debt instrument for U.S. tax purposes, and it does not necessarily clearly reflect income to apply the same treatment to a cash flow hedge that is not integrated with the related floating rate debt.

The Garlock and Munro Article has a more detailed discussion of the integrated transaction analogy and the reasoning behind recognizing the gain or loss on the termination of a cash flow hedge in the year of termination.

⁵³ CCA 201028039 (July 16, 2010).

⁵⁴ While the language in Reg. §1.446-4(e)(4) directly addresses using a spreading approach for hedges of qualified floating rate instruments, as set forth above, the introductory language to Reg. §1.446-4(e) states that “this paragraph (e) provides guidance in determining whether a taxpayer’s method of accounting satisfies the clear reflection requirement of paragraph (b) of this section.” Emphasis added. The regulations further note that even if the rules apply, the taxpayer’s method must clearly reflect income by meeting the matching requirement. As a result, because Reg. §1.446-4(e)(4) is simply guidance, it arguably is not required to be applied if its application does not satisfy the general matching requirement.

⁵⁵ A blend-and-extend transaction may take different forms. In some instances, multiple existing interest rate swaps will be “rolled” into a single, new interest rate swap (with a blended rate). In other instances, a single existing interest rate swap will be replaced with a new interest rate swap (with a longer term and a modified rate). For an overview of blend-and-extend transaction, see Kevin Jones, *How to use blend and extend interest rate swaps to optimize your hedging program*, Chatham Financial, www.chathamfinancial.com/insights/how-to-use-blend-and-extend-interest-rate-swaps-to-optimize-your-hedging-program (last visited March 26, 2023).

⁵⁶ Alternatively, the Hedge Timing Rules may not require the swap to be marked to market as

a result of the debt modification (even if the modification is a significant modification).

⁵⁷ For example, assume a taxpayer originally entered into an interest rate swap to hedge interest rate risk for the first five years of a seven-year debt. The taxpayer may at a later date enter into a blend-and-extend transaction pursuant to which the term of the swap is extended to match the term of the hedged debt instrument.

⁵⁸ Reg. §1.1001-1(a).

⁵⁹ See Reg. §1.1001-3.

⁶⁰ See James M. Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 Tax Notes 737 (April 29, 2002), at 738.

⁶¹ One exception is special rules under Reg. §1.1001-4 that address certain assignments of derivatives (including notional principal contracts, which would include interest rate swaps).

⁶² E.g., Michael Shulman & Nathan Tasso, *Changes to Derivatives ‘Pursuant to Their Terms’ (Part 1)*, TAX NOTES, May 1, 2017, p. 653; and Shulman & Tasso, *Changes to Derivatives ‘Pursuant to Their Terms’ (Part 2)*, TAX NOTES, May 8, 2017, p. 805.

⁶³ 1990-2 CB 191.

⁶⁴ See Rev. Rul. 90-109, 1990-2 CB 191. See also T.D. 8675, 61 FR 32926 (June 26, 1996), in addressing the drafting of the debt modification regulations in Reg. §1.1001-3 (discussed above) provides:

With the exception of those temporary and proposed regulations, the final regulations have not been expanded to cover the modification of financial instruments other than debt instruments. The modification of other instruments is less common than the modification of debt instruments, and the rules for modifications of debt instruments would not necessarily work well or be appropriate in determining whether modifications of other instruments result in exchanges under section 1001. For equity instruments in particular, the IRS and Treasury believe that the application of certain rules in these regulations would be inappropriate. Similarly, for contracts that are not debt instruments, the final regulations do not limit or otherwise affect the application of the “fundamental change” concept articulated in Rev. Rul. 90-109 (1990-2 CB 191), in which the IRS concluded that the exercise by a life insurance policyholder of an option to change the insured under the policy changed “the fundamental substance” of the contract, and thus was a disposition under section 1001.

The IRS appears to continue to believe that the principles underlying the “fundamental change” test are relevant to modifications to non-debt financial contracts. See, e.g., ILM 201547004 (November 20, 2015) (applying the principles of Rev. Rul. 90-109 to negotiated changes to an option contract), which states:

With respect to financial instruments other than debt instruments, the

“fundamental change” doctrine described in Rev. Rul. 90-109, 1990-2 CB 191, continues to apply. See Rev. Rul. 90-109 (concluding that the substitution of one employee for another as the party insured by a life insurance contract held by an employer was a “fundamental change” that resulted in the recognition by the employer of gain or loss on its contract); see also T.D. 8675 (Treas. Reg. §1.1001-3 debt modification regulation preamble stating that the final regulations do not limit or otherwise affect the application of the “fundamental change” concept articulated in Rev. Rul. 90-109).

The IRS also argued that the fundamental change doctrine was relevant to the modification of a variable prepaid forward contract in *McKelvey*, CA-2, 2018-2 USTC ¶150,424, 906 F3d 26 (2018). In *McKelvey* the Second Circuit Court of Appeals (reversing the Tax Court’s decision in 148 TC 312, Dec. 60,879 (2017)) stated that:

We agree with the Commissioner that extension of the valuation dates resulted in amended contracts that replaced the original contracts. The new valuation dates determined the share price upon which the number of shares to be delivered at settlement would be calculated, and these dates were seventeen months later than the dates for the original BofA contract and sixteen months later than the dates of the original MSI contract. As the Commissioner argues, “By extending the valuation dates, the parties fundamentally changed the bets that the VPFs represented, from bets on the value of Monster stock in September 2008 to bets on the value of Monster stock in January and February 2010.” Brief for Commissioner at 36.

As the Estate acknowledged in the Tax Court, “a ‘sufficiently fundamental or material change’ to an original contract that results in ‘a change in the fundamental substance of the original contract’ will be considered an exchange of the original contract for the amended contract.” Tax Court Brief for Estate at 43 (quoting Rev. Rul. 90-109, 1990-2 CB 191 (1990)). Extending the valuation dates was a fundamental change.

McKelvey, 906 F3d at 35.

⁶⁵ For example, if changes are made to the termination date (i.e., the maturity date) or rates (i.e., interest rates) under the contract that would give rise to a Code Sec. 1001 event if the instrument was debt for tax purposes, should such changes likewise result in the realization of gain or loss on the swap? See also James M. Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 Tax Notes 737, 764 (April 29, 2002), which suggests the IRS’s

ability to apply the debt modification rules to hedging transactions:

A notional principal contract would be part of a larger transaction when the contract is used as a hedge. The hedge timing regulations would generally allow gain from a deemed termination of a hedge of an ordinary obligation (typically a borrowing) to be spread over the remaining term of the hedged obligation so as to match the income and deductions from the hedge contract and the hedged item. These rules are quite limited in that they do not apply to hedges of capital assets. Their existence makes it easier for the Service to seek to apply a strict debt-like standard to swap modifications on the ground that resulting gains or losses will not be recognized currently in some common settings.

⁶⁶ See, e.g., Reg. §1.446-3(c)(2), (3) (defining “specified index” and “notional principal amount” in a manner that allows for changes in the index and/or notional principal amount that meet certain requirements, such as certain changes based on objective financial information).

⁶⁷ See also *Cottage Savings Assoc.*, S Ct, 91-1 USTC ¶150,187, 499 US 554, 111 S Ct 1503 (1991) (holding that an exchange of one mortgage pool for another resulted in a Code Sec. 1001 taxable exchange, even when the differences between the mortgage pools were minimal). For a further discussion on the tax treatment of modifications of non-debt financial transactions, see Michael Shulman & Nathan Tasso, *Changes to Derivatives ‘Pursuant to Their Terms’ (Part 1)*, TAX NOTES, May 1, 2017, p. 653, at 664 and 665; Shulman & Tasso, *Changes to Derivatives ‘Pursuant to Their Terms’ (Part 2)*, TAX NOTES, May 8, 2017, p. 805, at 819.

⁶⁸ We observe that even if the blend and extend of the swap did not result in a Code Sec. 1001 event, if the debt was significantly modified at the same time, the Hedge Timing Rules may nevertheless require the swap to be marked to market. See Reg. §1.446-4(e)(6). We discuss the application of the Hedge Timing Rules to a significant modification of a debt instrument above.

⁶⁹ Interestingly, in a 2001 Field Service Advice (FSA) the IRS concluded that a taxpayer was not entitled a deduction for a termination payment deemed to be paid in a blend-and-extend transaction on the grounds that an actual payment was not made. See FSA 200145010 (August 2,

2001). The analysis in the guidance is inconsistent with how deemed payments are accounted for in other contexts (for example, withholding under Code Sec. 1441) and is generally not followed by practitioners. The FSA also does not apply the Hedge Timing Rules although the facts indicate that the swaps were entered into in connection with variable rate borrowings.

Taxpayers should also be careful to reidentify the modified interest rate swap as a tax-hedging transaction on the date of the blend-and-extend transaction.

⁷⁰ Earlier in this article, we considered whether the Hedge Timing Rules *require* taxpayers to mark a tax-hedging transaction to market on account of a significant modification of the hedged debt instrument. As we discussed, there is very little guidance addressing this point and colorable arguments to support recognition (or not). For this reason, if the blend-and-extend transaction *did not* give rise to a Code Sec. 1001 transaction with respect to the swap, the treatment of the swap under the Hedge Timing Rules would be a bit unclear.

⁷¹ Reg. §1.446-4(e)(4).

⁷² See Rev. Rul. 2002-71, 2002-2 CB 763; CCA 201028039 (July 16, 2010).

⁷³ Reg. §1.446-3(g)(4).

