Part I

Section 446.--General Rule for Methods of Accounting

(Also 26 CFR 1.446-4)

Rev. Rul. 2002-71

ISSUE

When should a taxpayer take into account gain or loss on the termination of a notional principal contract (NPC) that hedges a portion of the term of a debt instrument issued by the taxpayer?

FACTS

Situation 1

Taxpayer TP uses the calendar year as its taxable year. On the first day of Year 1, TP issues a debt instrument. The debt instrument has a 10-year term and provides for interest to be paid annually at a fixed rate. Contemporaneously with the issuance of the debt instrument, TP also enters into an NPC with a 5-year term that converts the fixed rate payments under the debt instrument into floating rate payments. That is, the NPC provides for TP to receive payments equal to the product of the fixed rate on the debt instrument and a notional amount equal to the principal amount of the debt instrument in exchange for payments by TP equal to the product of a floating rate and
the same notional amount. Pursuant to § 1.1221-2(f), TP properly identifies the NPC as a hedging transaction covering Year 1 through Year 5 of the debt instrument and complies with the other requirements necessary for the NPC to be treated as a hedge under §§ 1.1221-2 and 1.446-4. TP terminates the NPC on the last day of Year 2 and either receives or makes a termination payment.

Situation 2

The facts are the same as Situation 1, but, in addition, TP retires the debt instrument in Year 4.

LAW

Section 1.446-4(a) provides that a hedging transaction as defined in § 1.1221-2(b) must be accounted for under the rules set forth in § 1.446-4.

Section 1.446-4(b) provides that the method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. Section 1.446-4(b) further provides that to clearly reflect income, the method used for a hedging transaction must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item being hedged.

Section 1.446-4(e)(4) provides that gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by a taxpayer, must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. A hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, for example, generally is accounted for using constant yield principles. Thus, 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.
Section 1.446-4(e)(4) provides, as an example, that gain or loss realized on a
transaction that hedged an anticipated fixed rate borrowing for its entire term is
accounted for, solely for purposes of § 1.446-4, as if it decreased or increased the issue
price of the debt instrument. However, in all events, the taxpayer’s method, as actually
applied to the taxpayer’s hedging transactions, must clearly reflect income by meeting
the matching requirement of § 1.446-4(b). See § 1.446-4(e) (introductory sentences).

ANALYSIS

Situation 1

Unlike the hedging transaction described in § 1.446-4(e)(4) that hedges a fixed
rate borrowing over its entire term, TP’s NPC does not hedge the entire term of the debt
instrument. Rather, TP’s NPC hedges, and relates only to, Year 1 through Year 5 of
the 10-year term of the debt instrument. Prior to its termination on the last day of Year
2, the NPC would have continued to hedge Year 3 through Year 5 of the debt
instrument, and TP generally would have been required to take into account the
remaining income, deduction, gain, or loss over the period from Year 3 through Year 5.
The termination payment made or received by TP represents the present value of the
extinguished rights and obligations under the NPC for Year 3 through Year 5.
Therefore, the gain or loss from the hedging transaction relates to Year 3 through Year
5. To clearly reflect income in accordance with the matching requirement of
§ 1.446-4(b), TP must take into account the gain or loss from terminating the NPC over the period from Year 3 through Year 5.

**Situation 2**

Following the analysis from **Situation 1**, TP would have already taken into account in Year 3 a portion of the gain or loss from termination of the NPC in Year 2. However, upon retiring the debt instrument in Year 4, TP's remaining gain or loss from the termination of the NPC should be recognized in order to match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item being hedged.

**HOLDING**

(1) In **Situation 1**, TP must account for the gain or loss arising from terminating the NPC over the period from Year 3 through Year 5, the remaining period to which the terminated hedge relates.

(2) In **Situation 2**, TP takes into account in Year 3 a portion of the gain or loss arising from the termination of the NPC and takes into account in Year 4 the remaining balance of the gain or loss from the terminated hedge.

**DRAFTING INFORMATION**

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