

Top ten tax considerations for hedging transactions



As volatility in all asset classes has recently increased and the global economic outlook remains uncertain, the need to manage business risks effectively is more important than ever. Whether that risk management comes in the form of entering into interest rate swaps and caps to manage interest rate risk on borrowings or hedging price or currency risk with respect to inventory purchases and sales, there are several tax issues that should be at the forefront of any risk management discussions.

To assist you in navigating these issues, the Financial Institutions & Products (FIP) group in the KPMG Washington National Tax (WNT) practice has outlined the following top considerations:

01

Can any transaction entered into to manage a business risk be a hedge for tax purposes?

No. Generally, only transactions entered into in the normal course of a taxpayer's trade or business primarily to manage interest rate, price, or currency risk with respect to borrowings, ordinary obligations, and ordinary property are hedging transactions.

02

Can a taxpayer hedge on an affiliate's behalf?

Generally, no. To qualify as a tax hedging transaction, generally both the qualifying business risk and the hedging transaction must be at the same taxpayer. There is an exception, however, for members of a U.S. consolidated group (unless an election is made).



03

Does a book designation of a transaction as a hedge qualify the transaction as a tax hedge?

No. While book designations and descriptions are helpful, they are not determinative for tax purposes; the tax rules have their own standards and identification requirements.

04

When should hedging transactions be identified as such for tax purposes?

A hedging transaction is required to be identified as such in a taxpayer's books and records no later than the close of the business day on which the hedging transaction is entered into. Within 35 days of entering into a hedging transaction, the taxpayer must also identify the risk that is being hedged and the taxpayer's method of accounting for the hedging transaction.

05

What should the identification say?

It depends on the specific risk being hedged and how it is being hedged. At a minimum, it must be clear, unambiguous, and expressly state that the identification is for tax purposes. Tax identifications can be specific (i.e., relate to a specific transaction) or done in aggregate (i.e., relate to a group or class of transactions).

06

What if the identification is missed or done incorrectly?

If a hedging transaction is not properly identified, the risk is that gain on the transaction will be ordinary and loss will be capital under special character whipsaw rules that can apply to unidentified hedges.

07

Is there a way to subsequently correct a missed or incorrect identification?

The hedging regulations do provide for an "inadvertent error" exception under which a taxpayer is permitted to treat gain or loss from an unidentified transaction as ordinary income or loss if certain requirements are met. This exception generally can only be relied on once, however.

08

For tax accounting for hedging transactions, can tax follow book?

It depends. For tax purposes, the method of accounting for a hedging transaction must clearly reflect income by reasonably matching 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. What this means in practice depends on the facts and, depending on the situation, these hedge timing rules can lead to some unexpected timing consequences.



09

Can hedges be recycled?

In general, hedges can be recycled (i.e., used to hedge another or new business risk). Recycled hedges are subject to special rules that can lead to some unexpected results.

10

Do the tax hedging rules allow for offshore risk management?

Yes. There are additional complex rules relating to the hedging activities of controlled foreign corporations and qualified business units that may impact the US parent's Subpart F inclusions and GILTI calculations.



Contact us

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