Ruminations on Identification

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Richard M. Lipton, Senior Counsel, Baker McKenzie, 1900 North Pearl Street, Suite 1500, Dallas, Texas 75201, richard.lipton@bakermckenzie.com; Daniel Cullen, Partner, Baker McKenzie, Chicago, Illinois, Daniel.Cullen@bakermckenzie.com; and Samuel P. Grilli, Partner, Baker & McKenzie LLP, 300 East Randolph Street, Suite 5000, Chicago, Illinois 60601, samuel.grilli@bakermckenzie.com.

A recent decision, *YA Global Investments LP v. Commissioner*, has caused your editors to focus on the underlying purpose of the "identification requirements" that often appear in the Code. The decision in *YA Global* will be the subject of a full article in The Journal, and this Shop Talk will not address many of the issues that will be covered there. However, the aspect of the decision that is the genesis of this column is the court's conclusion that an identification of assets as held for investment was not sufficient for purposes of the dealer requirements in Section 475, unless the identification specified in writing at the time it was made, the applicable subsection of Section 475 that applied to the assets held for investment.

Briefly, YA Global was a Cayman-organized master fund that used a customary structure, i.e., it had a Cayman feeder for foreign or exempt investors and a U.S. feeder for U.S. resident investors. It had a management company and investment advisor based in the U.S., Yorkville Advisors (Yorkville), which were active in the selection of investments. YA Global effectively operated as a merchant bank, using its own funds to make custom-designed convertible loans that had a significant equity component. The loans were treated as debt held for investment by YA Global, and almost half of the loans defaulted, but a few were huge winners, resulting in large equity kickers. YA Global consistently treated all of the convertible loans as held for investment, and it treated itself as an offshore investor in U.S. debt instruments, meaning that there was no withholding on interest paid and all of the gains were capital gains.

The Tax Court's decision concluded that (1) Yorkville was an agent of YA Global, (2) the presence of an agent in the U.S. caused YA Global to be treated as conducting business in the U.S., (3) YA Global's business should be treated as a "dealer in securities" for purposes of Section 475, (4) YA Global failed to adequately identify that the convertible loans were assets held for investment for purposes of Section 475 because the applicable Code provisions were not included in its books and records, and (5) various withholding taxes and penalties applied. Again, this Shop Talk will not address most of these points (leaving that discussion to the future article) but we want to discuss the theory underlying the identification rule at issue in item (4) above.

The identification rule in Section 475 requires a dealer in securities to properly identify assets that it holds for investment at the time such assets are acquired in order to exempt those assets from the "mark to market" regime that otherwise applies to all of the securities held by a dealer. The fact that there is an identification requirement, and that identification must be made at the time of acquisition, makes sense, because otherwise taxpayers would use hindsight to take the position that any asset that had appreciated in value was held for investment (and not subject to current mark-to-market gain recognition as ordinary income) while also claiming that any asset that had declined in value was not held for investment (so that the resulting ordinary losses could be accelerated).

There are many other identification requirements in the Code, most of which serve the same purpose, i.e., to prevent taxpayers from taking a "heads I win, tails the Government loses" approach. One of the most commonly-encountered "identification requirements" involves interest-rate hedges, which a taxpayer is required under Section 1221 to identify at the time they are entered into. For example, a taxpayer enters into a garden-variety interest-rate swap to offset the economic risk that accompanies a floating rate debt owed by (or possibly owed to) the taxpayer. If the swap is identified in the taxpayer's books and records as a hedging transaction at the time it is entered into, all of the gains and losses related to the swap would be treated as ordinary (and correlated to the interest income or deductions on the underlying loan). In contrast, if no identification is timely made in the taxpayer's books and records, the resulting income or loss would be capital in nature and could not be used for tax purposes to offset the related interest income or deduction. The identification must be made in the taxpayer's books and records on the date that the swap is entered into, although there is flexibility in how the hedging transaction can be identified, as long as the identification is clear and unambiguous.

This treatment of swap transactions is equitable because, at the time the swap is entered into, the taxpayer does not know whether the swap will result in a gain or a loss. It would be in the taxpayer's interest to delay making a "swap identification" until the underlying economic results are known, but that would be inappropriately disadvantageous to the fisc – taxpayers would always take the position that is favorable to them from a tax perspective on a post-facto basis. The requirement that identifications be made at the time the swap transaction is entered into protects the impartiality of the tax system by requiring a taxpayer to be "up front" about the purpose for the swap.

Another area where taxpayers are required to make an identification "up front" involves like-kind exchanges under Section 1031, since the taxpayer in a forward exchange must identify the replacement property within 45 days of the sale of the relinquished property (and acquire the property within 180 days). Again, the purpose of this requirement is to prevent taxpayers from taking a "post facto" position that a property that is acquired within 180 days was the "intended" target of an exchange, which would have provided more flexibility than Congress desired. The replacement property must be identified in writing (usually through a submission to the qualified intermediary) by the close of the 45th day after the sale of the relinquished property, although there is a fair degree of flexibility concerning the manner in which

the replacement property is identified. For example, a legal description of the replacement property is not required, and a street address will usually suffice, although there is flexibility in that regard, too. As long as the identification is clear and unambiguous, so that a disinterested party would know which property had been identified, that is sufficient.

The purpose for the identification requirements with respect to hedges and like-kind exchanges is to take away from taxpayers the ability to use a rear-view mirror for tax gamesmanship. The law generally allows a taxpayer to make its own bed, but the taxpayer must lie in the bed that it made. These identification requirements are consistent with that legal underpinning and theory, particularly given that taxpayers have some flexibility as to the manner in which an identification is made, as long as it is clear and unambiguous.

What is troubling about the decision in *YA Global* is that the taxpayer did identify in its books and records, and all of its reports to its investors and financial statements, that the convertible securities that it acquired were assets held for investment. So there is no doubt that is what YA Global intended – and what it did. But the court concluded that these identifications were not sufficient because there was no reference to Section 475 in the identifications, even though YA Global had no inkling that it was subject to Section 475 until the IRS asserted that position on audit. Thus, YA Global was required to apply the mark-to-market rules with respect to its winning investments (and pay withholding taxes) even though YA Global had always (and consistently) treated those assets as held for investment.

This conclusion is concerning since it gave the IRS the opportunity to use its rear-view mirror to raise revenue. If a disproportionate share of the convertible loans entered into by YA Global had incurred a loss – or if the few large winners had not emerged – it's a pretty good guess that the government would not have argued that YA Global was subject to "mark to market" reporting (or that the identification of these securities as "held for investment" was insufficient). Rather than strict technical requirements that require perfect compliance, the theory behind these identification requirements is to prevent both sides (neither taxpayers nor the government) from making biased retroactive claims to their advantage. The court's decision seems to have missed the fundamental legal purpose for identification requirements across the Code.

We are curious if our readers have thoughts about other identification requirements in the Code, whether they are consistent with this legal theory, and how our readers believe that such requirements should be applied.