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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8554]

RIN 1545-AS96

Clear Reflection of Income in the Case of Hedging Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to accounting for business hedging transactions. Elsewhere in the Rules and Regulations portion of this issue of the *Federal Register*, the Internal Revenue Service is issuing final regulations to clarify the character of gain or loss recognized from the sale or exchange of property that is part of a business hedge. The final regulations in this document are needed to provide guidance to taxpayers regarding when gain or loss from common business hedging transactions is taken into account for tax purposes.

DATES: These regulations are effective July 18, 1994.

For dates of applicability of these regulations, see § 1.446-4(g).

FOR FURTHER INFORMATION CONTACT: Jo Lynn Ricks of the Office of the Assistant Chief Counsel (Financial Institutions and Products), Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (attn: CC:DOM:FI&P). Telephone (202) 622-3920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1412. The estimated annual burden per respondent or recordkeeper varies from .1 to 10 hours, depending on individual circumstances, with an estimated average of .5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS

Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On October 20, 1993, the Service published in the *Federal Register* (58 FR 54077) a notice of proposed rulemaking (FI-54-93) relating to accounting for business hedging transactions. The notice also contained proposed amendments to regulations under sections 446 (relating to accounting for notional principal contracts) and 461 (relating to general rules on the taxable year of deduction).

On January 19, 1994, the Service held a public hearing on the proposed regulations. In addition, the Service received a number of written comments on the proposed regulations. The proposed regulations, with certain modifications and changes, are adopted as final regulations. The changes, and several of the suggestions that were not adopted, are discussed below.

Explanation of Provisions

Under the final regulations, a hedging transaction defined in § 1.1221-2(b) must be accounted for under the rules of § 1.446-4. This requirement applies regardless of whether the character of the gain or loss on the hedging transaction is determined under § 1.1221-2. Thus, for example, certain section 988 transactions that are described in § 1.1221-2(b) are accounted for under the rules of this section.

The regulations require taxpayers to clearly reflect income by reasonably matching the timing of the income, deduction, gain, or loss from a hedging transaction with the timing of income, deduction, gain, or loss from the hedged item or items. The regulations generally provide significant flexibility to taxpayers in determining the appropriate method of accounting for their different hedging transactions.

Some commentators suggested that any hedge accounting method employed by a taxpayer for financial statement purposes should be treated as satisfying the matching requirement. Because the financial accounting standards for hedges are in a state of development, however, the final regulations do not expressly sanction the use of financial accounting methods. Nevertheless, the Service and Treasury expect that the hedge accounting methods employed by most taxpayers for financial accounting

purposes will satisfy the clear reflection standard in the final regulations.

The final regulations require taxpayers to maintain books and records containing a description of the accounting method used for each type of hedging transaction in sufficient detail to demonstrate how the clear reflection standard is met. For each hedging transaction, in addition to the identification required by the regulations under section 1221, the final regulations require whatever more specific identification is necessary to verify the application of the method of accounting used by the taxpayer for that transaction.

Various commentators requested that the regulations provide specific examples or other guidance on the type of additional information the Service expects taxpayers to provide. Because the identification that is needed depends upon the method of accounting being used and the types of items or risk being hedged, however, specific rules cannot be provided. For example, taxpayers using a mark-and-spread method of accounting for aggregate hedges will identify the spread period in their books and records, but taxpayers using other methods will not.

The proposed regulations provided no specific guidance on the appropriate method of accounting for global hedges and other hedges of aggregate risk. The preamble, however, solicited comments on this issue. Many commentators suggested that the regulations should provide for an aggregate hedge account, in which both the hedging transactions and the hedged items would be accounted for under a particular method. Methods suggested included a periodic mark-to-market method modeled on the mixed straddle accounts of section 1092(b) and realization-based methods with loss-deferral or loss-limitation provisions.

Because these regulations concern only accounting for hedging transactions, the Service and Treasury are concerned about expanding the regulations to allow mark-to-market accounting for hedged items in an aggregate hedge account. Many taxpayers are not currently using mark-to-market accounting, and general changes to their methods of accounting for hedged items would create issues that are beyond the scope of the regulations. Realization-based methods of accounting for aggregate hedge accounts would only be appropriate if coupled with loss-deferral or loss-limitation provisions, and the Service and Treasury are concerned about their authority to impose these restrictions. Accordingly, the regulations do not

adopt the suggestion that an aggregate hedge account should be permitted.

The final regulations restate the general matching rule for hedges of aggregate risk and require taxpayers to match the timing of income, deduction, gain, or loss from the hedging transaction to the timing of the aggregate income, deduction, gain, or loss from the items being hedged. The regulations further provide that the "mark-and-spread" method currently employed by many taxpayers to account for hedges of aggregate risk for financial accounting purposes may provide an appropriate and reasonable match. Under the mark-and-spread method described in the regulations, the taxpayer periodically marks the hedging transactions to market and takes the gain or loss into account over the period for which the hedge is intended to reduce exposure to risk. Similar spreading applies to realized income, deduction, gain, and loss. Under this method, the period over which the hedging transaction is intended to reduce risk (and thus the period over which the gains and losses are taken into account) may change over time, depending upon a taxpayer's particular hedging strategies. The period used, however, must be reasonable and consistent with those strategies. It is anticipated that the identification and recordkeeping required by §§ 1.446-4(d) and 1.1221-2(e) will support the reasonableness of a taxpayer's spread period.

The mark-and-spread method is not the only method that clearly reflects income for hedges of aggregate risk. The final regulations also state that, if a taxpayer hedges its aggregate risk with a notional principal contract, taking into account gains and losses in accordance with § 1.446-3 of the regulations may clearly reflect income. Other methods of accounting also may be appropriate. Like the proposed regulations, the final regulations allow flexibility in attaining the reasonable matching required by the general rule.

The proposed regulations contained several provisions applicable to inventory hedging transactions. The general rule in the proposed regulations was that gains and losses on hedges of inventory purchases may be taken into account at the same time they would be taken into account if they were elements of inventory cost. Similarly, gains and losses on hedges of sales of inventory may be taken into account at the same time they would be if they were elements of gross sales proceeds.

In response to comments, the final regulations clarify the general rule for inventory hedges and extend it to hedges of aggregate inventory risk. A

hedge of an aggregate risk cannot be associated with particular purchase or sales transactions. Accordingly, the final regulations provide that taxpayers may account for hedges of purchases under the mark-and-spread method, with the modification that the gain or loss spread to particular periods is taken into account in the same period it would have been if it had been an increase or decrease to inventory cost incurred in the particular period. Similarly, a taxpayer may account for hedges of sales of inventory under a mark-and-spread approach, with the gain or loss that is spread to a particular period taken into account in the same period it would have been if it had been an increase or decrease to gross sales proceeds.

The final regulations clarify certain simplified methods of accounting for inventory hedges that were provided in the proposed regulations. First, the proposed regulations provided a special rule allowing taxpayers to take hedging gains and losses into account when realized, if the hedging transactions are closed when the hedged inventory items are sold and units are included in inventory at cost. Because the general rule has been clarified to encompass this approach, this provision is not separately stated in the final regulations.

Second, the final regulations continue the simplified method of taking into account gains and losses on hedges of both purchases and sales as though those gains and losses were elements of inventory cost. The regulations make it clear that it is realized gains and losses that are so taken into account. The regulations also continue to prohibit the use of this method by LIFO taxpayers. The Service and Treasury believe that significant distortions of income might result if gains and losses on sales hedges became buried in inventory cost layers.

Finally, the simplified method of marking to market inventory hedging transactions is clarified to allow the mark-to-market gain or loss to be taken into account immediately, instead of being treated as an element of cost or gross proceeds. The final regulations continue the proposed prohibition on the use of this method by LIFO taxpayers and by taxpayers employing a lower-of-cost-or-market method of accounting for inventory. Moreover, this method may be used only if items are held in inventory for short periods of time.

The final regulations clarify when the built-in gain or loss on the hedging transaction is taken into account where a taxpayer disposes of the hedged item but does not dispose of the hedging transaction. In this situation, the

taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item. This matching may be met by marking to market the hedge on the date of disposition of the hedged item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period, the taxpayer may match the realized gain or loss on the hedging transaction with the gain or loss on the disposed item. However, if the taxpayer intends to dispose of the hedging transaction within a reasonable period and the hedging transaction is still in place after that period, the taxpayer must match the gain or loss on the hedge at the end of the reasonable period with the gain or loss on the disposed item. For these purposes, a reasonable period is generally seven days.

The final regulations provide rules of accounting for recycled hedges (positions that previously hedged one item but that the taxpayer has re-identified as hedging another). The new rules are similar to those of the proposed regulations for treatment of hedges after disposition of the hedged asset or liability. A taxpayer recycling a hedge of a particular hedged item to serve as a hedge of another item must match the built-in gain or loss on the hedge at the time of the recycling to the income, deduction, gain, or loss on the original hedged item. Income, deduction, gain, or loss on the hedge after the recycling must be matched to the income, deduction, gain, or loss on the new hedged item, items, or aggregate risk. This matching may be accomplished by marking the hedge to market at the time of the recycling.

The preamble to the proposed regulations invited comments on the appropriate accounting for anticipatory hedges where the anticipated transaction is not consummated. Most commentators suggested that gains or losses be taken into account when realized. Others suggested that any gain or loss realized on the hedging transaction be taken into account at the same time it would have been taken into account if the anticipated transaction had been consummated and the timing of the gain or loss on the hedge had been matched with the timing of the gain or loss on the hedged item. Still others suggested an arbitrary spread period.

The first suggestion was adopted. The regulations provide that, if an anticipated transaction is not consummated, any income, deduction, gain, or loss on the hedging transaction is taken into account when realized. The regulations provide that a transaction is

consummated upon the occurrence, within a reasonable time period, of either the anticipated transaction or a different but similar transaction for which the hedge serves to reasonably reduce risk. The Service will view the "similar transaction" parameters broadly to prevent taxpayers from realizing hedging gains and losses selectively by abandoning a planned transaction and substituting a similar transaction.

Finally, the regulations grant consent for taxpayers to change their methods of accounting for hedging transactions. The change must be made for transactions entered into on or after October 1, 1994, and must be made for the taxable year containing that date. The change is made on a cut-off basis. Therefore, no items of income or deduction are omitted or duplicated, and no adjustment under section 481 is allowed or permitted. Because the consent does not extend to changes for a subsequent tax year, consent for such a change must be requested according to the procedures established under § 1.446-1(e).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Jo Lynn Ricks, Office of Assistant Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.446-3 is amended as follows:

1. The first sentence of paragraph (h)(2) is revised.
2. The second sentence of the introductory language of paragraph (h)(5) is revised.
3. The revisions read as follows:

§ 1.446-3 Notional principal contracts.

* * * * *

(h) * * *

(2) *Taxable year of inclusion and deduction by original parties.* Except as otherwise provided (for example, in section 453, section 1092, or § 1.446-4), a party to a notional principal contract recognizes a termination payment in the year the contract is extinguished, assigned, or exchanged. * * *

* * * * *

(5) * * * The contracts in the examples are not hedging transactions as defined in § 1.1221-2(b), and all of the examples assume that no loss-deferral rules apply.

* * * * *

Par. 3. Section 1.446-4 is added to read as follows:

§ 1.446-4 Hedging transactions.

(a) *In general.* Except as provided in this paragraph (a), a hedging transaction as defined in § 1.1221-2(b) (whether or not the character of gain or loss from the transaction is determined under § 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.

(1) *Trades or businesses excepted.* A taxpayer is not required to account for hedging transactions under the rules of this section for any trade or business in which the cash receipts and disbursements method of accounting is used or in which § 1.471-6 is used for inventory valuations if, for all prior taxable years ending on or after September 30, 1993, the taxpayer met the \$5,000,000 gross receipts test of section 448(c) (or would have met that test if the taxpayer were a corporation or partnership). A taxpayer not required

to use the rules of this section may nonetheless use a method of accounting that is consistent with these rules.

(2) *Coordination with other sections.* This section does not apply to—

(i) Any position to which section 475(a) applies;

(ii) Any section 988 hedging transaction if the transaction is integrated under § 1.988-5 or if other regulations issued under section 988(d) (or an advance ruling described in 1.988-5(e)) govern when gain or loss from the transaction is taken into account; or

(iii) The determination of the issuer's yield on an issue of tax-exempt bonds for purposes of the arbitrage restrictions to which § 1.148-4(h) applies.

(b) *Clear reflection of income.* The method of accounting used by a taxpayer 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. Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. For example, where a hedge and the item being hedged are disposed of in the same taxable year, taking realized gain or loss into account on both items in that taxable year may clearly reflect income. In the case of many hedging transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.

(c) *Choice of method and consistency.* For any given type of hedging transaction, there may be more than one method of accounting that satisfies the clear reflection requirement of paragraph (b) of this section. A taxpayer is generally permitted to adopt a method of accounting for a particular type of hedging transaction that clearly reflects the taxpayer's income from that type of transaction. See paragraph (e) of this section for requirements and limitations on the taxpayer's choice of method. Different methods of accounting may be used for different types of hedging transactions and for transactions that hedge different types of items. Once a taxpayer adopts a method of accounting, however, that method must be applied consistently and can only be changed with the consent of the Commissioner, as provided by section 446(e) and the regulations and procedures thereunder.

(d) *Recordkeeping requirements—(1) In general.* The books and records maintained by a taxpayer must contain

a description of the accounting method used for each type of hedging transaction. The description of the method or methods used must be sufficient to show how the clear reflection requirement of paragraph (b) of this section is satisfied.

(2) *Additional identification.* In addition to the identification required by § 1.1221-2(e), the books and records maintained by a taxpayer must contain whatever more specific identification with respect to a transaction is necessary to verify the application of the method of accounting used by the taxpayer for the transaction. This additional identification may relate to the hedging transaction or to the item, items, or aggregate risk being hedged. The additional identification must be made at the time specified in § 1.1221-2(e)(2) and must be made on, and retained as part of, the taxpayer's books and records.

(3) *Transactions in which character of gain or loss is not determined under § 1.1221-2.* A section 988 transaction, as defined in section 988(c)(1), or a qualified fund, as defined in section 988(c)(1)(E)(iii), is subject to the identification and recordkeeping requirements of § 1.1221-2(e). See § 1.1221-2(a)(4)(i).

(e) *Requirements and limitations with respect to hedges of certain assets and liabilities.* In the case of certain hedging transactions, 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. Even if these rules are satisfied, however, the taxpayer's method, as actually applied to the taxpayer's hedging transactions, must clearly reflect income by meeting the matching requirement of paragraph (b) of this section.

(1) *Hedges of aggregate risk—(i) In general.* The method of accounting used for hedges of aggregate risk must comply with the matching requirements of paragraph (b) of this section. Even though a taxpayer may not be able to associate the hedging transaction with any particular item being hedged, the timing of income, deduction, gain, or loss from the hedging transaction must be matched with the timing of the aggregate income, deduction, gain, or loss from the items being hedged. For example, if a notional principal contract hedges a taxpayer's aggregate risk, taking into account income, deduction, gain, or loss under the provisions of § 1.446-3 may clearly reflect income. See paragraph (e)(5) of this section.

(ii) *Mark-and-spread method.* The following method may be appropriate for taking into account income,

deduction, gain, or loss from hedges of aggregate risk:

(A) The hedging transactions are marked to market at regular intervals for which the taxpayer has the necessary data, but no less frequently than quarterly; and

(B) The income, deduction, gain, or loss attributable to the realization or periodic marking to market of hedging transactions is taken into account over the period for which the hedging transactions are intended to reduce risk. Although the period over which the hedging transactions are intended to reduce risk may change, the period must be reasonable and consistent with the taxpayer's hedging policies and strategies.

(2) *Hedges of items marked to market.* In the case of a transaction that hedges an item that is marked to market under the taxpayer's method of accounting, marking the hedge to market clearly reflects income.

(3) *Hedges of inventory—(i) In general.* If a hedging transaction hedges purchases of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory. Similarly, if a hedging transaction hedges sales of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of sales proceeds. If a hedge is associated with a particular purchase or sales transaction, the gain or loss on the hedge may be taken into account when it would be taken into account if it were an element of cost incurred in, or sales proceeds from, that transaction. As with hedges of aggregate risk, however, a taxpayer may not be able to associate hedges of inventory purchases or sales with particular purchase or sales transactions. In order to match the timing of income, deduction, gain, or loss from the hedge with the timing of aggregate income, deduction, gain, or loss from the hedged purchases or sales, it may be appropriate for a taxpayer to account for its hedging transactions in the manner described in paragraph (e)(1)(ii) of this section, except that the gain or loss that is spread to each period is taken into account when it would be if it were an element of cost incurred (purchase hedges), or an element of proceeds from sales made (sales hedges), during that period.

(ii) *Alternative methods for certain inventory hedges.* In lieu of the method described in paragraph (e)(3)(i) of this section, other simpler, less precise

methods may be used in appropriate cases where the clear reflection requirement of paragraph (b) of this section is satisfied. For example:

(A) Taking into account realized gains and losses on both hedges of inventory purchases and hedges of inventory sales when they would be taken into account if the gains and losses were elements of inventory cost in the period realized may clearly reflect income in some situations, but does not clearly reflect income for a taxpayer that uses the last-in, first-out method of accounting for the inventory; and

(B) Marking hedging transactions to market with resulting gain or loss taken into account immediately may clearly reflect income even though the inventory that is being hedged is not marked to market, but only if the inventory is not accounted for under either the last-in, first-out method or the lower-of-cost-or-market method and only if items are held in inventory for short periods of time.

(4) *Hedges of debt instruments.* 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. For example, 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 this section, as if it decreased or increased the issue price of the debt instrument.

(5) *Notional principal contracts.* The rules of § 1.446-3 govern the timing of income and deductions with respect to a notional principal contract unless, because the notional principal contract is part of a hedging transaction, the application of those rules would not result in the matching that is needed to satisfy the clear reflection requirement of paragraph (b) and, as applicable, (e)(4) of this section. For example, if a notional principal contract hedges a debt instrument, the method of accounting for periodic payments described in § 1.446-3(e) and the methods of accounting for nonperiodic

payments described in § 1.446-3(f)(2)(iii) and (v) generally clearly reflect the taxpayer's income. The methods described in § 1.446-3(f)(2)(ii) and (iv), however, generally do not clearly reflect the taxpayer's income in that situation.

(6) *Disposition of hedged asset or liability.* If a taxpayer hedges an item and disposes of, or terminates its interest in, the item but does not dispose of or terminate the hedging transaction, the taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item. To meet this requirement, the taxpayer may mark the hedge to market on the date it disposes of the hedged item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period, however, it may be appropriate to match the realized gain or loss on the hedging transaction with the gain or loss on the disposed item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period and the hedging transaction is not actually disposed of within that period, the taxpayer must match the gain or loss on the hedge at the end of the reasonable period with the gain or loss on the disposed item. For purposes of this paragraph (e)(6), a reasonable period is generally 7 days.

(7) *Recycled hedges.* 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 § 1.1221-2(c)(2), 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, items, or aggregate risk. Income, deduction, gain, or loss attributable to the period after the recycling must be matched to the new hedged item, items, or aggregate risk under the principles of paragraph (b) of this section.

(8) *Unfulfilled anticipatory transactions—(i) In general.* If a taxpayer enters into a hedging transaction to reduce risk with respect to an anticipated asset acquisition, debt issuance, or obligation, and the anticipated transaction is not consummated, any income, deduction, gain, or loss from the hedging transaction is taken into account when realized.

(ii) *Consummation of anticipated transaction.* A taxpayer consummates a transaction for purposes of paragraph (e)(8)(i) of this section upon the occurrence (within a reasonable interval around the expected time of the anticipated transaction) of either the anticipated transaction or a different but

similar transaction for which the hedge serves to reasonably reduce risk.

(9) *Hedging by members of a consolidated group.* [Reserved.]

(f) *Type or character of income and deduction.* The rules of this section govern the timing of income, deduction, gain, or loss on hedging transactions but do not affect the type or character of income, deduction, gain, or loss produced by the transaction. Thus, for example, the rules of paragraph (e)(3) of this section do not affect the computation of cost of goods sold or sales proceeds for a taxpayer that hedges inventory purchases or sales. Similarly, the rules of paragraph (e)(4) of this section do not increase or decrease the interest income or expense of a taxpayer that hedges a debt instrument or a liability.

(g) *Effective date.* This section applies to hedging transactions entered into on or after October 1, 1994.

(h) *Consent to change methods of accounting.* The Commissioner grants consent for a taxpayer to change its methods of accounting for transactions that are entered into on or after October 1, 1994, and that are described in paragraph (a) of this section. This consent is granted only for changes for the taxable year containing October 1, 1994. The taxpayer must describe its new methods of accounting in a statement that is included in its Federal income tax return for that taxable year.

Par. 4. In § 1.461-1, paragraph (a)(2)(iii)(B) is revised to read as follows:

§ 1.461-1 General rules for taxable year of deduction.

- (a) * * *
- (2) * * *
- (iii) * * *

(B) If the liability of a taxpayer is subject to section 170 (charitable contributions), section 192 (black lung benefit trusts), section 194A (employer liability trusts), section 468 (mining and solid waste disposal reclamation and closing costs), or section 468A (certain nuclear decommissioning costs), the liability is taken into account as determined under that section and not under section 461 or the regulations thereunder. For special rules relating to certain loss deductions, see sections 165(e), 165(i), and 165(l), relating to theft losses, disaster losses, and losses from certain deposits in qualified financial institutions.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. Section 602.101(c) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

CFR part or section where identified and described	Current OMB control No.
1.446-4(d)	1545-1412

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved:
Samuel Y. Sessions,
Acting Assistant Secretary of Treasury.
[FR Doc. 94-16868 Filed 7-13-94; 9:10 am]
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26 CFR Parts 1 and 602

[TD 8555]

RIN 1545-AR73

Hedging Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations clarifying the character of gain or loss from business hedges. In general, the regulations treat gain or loss on most hedging transactions as ordinary rather than capital. The regulations are needed to provide guidance to businesses entering into hedging transactions and to serve as a basis for resolving pending cases involving gains and losses from hedging.

DATES: These regulations are effective July 18, 1994, except that the amendments relating to the removal of § 1.1221-2T are effective October 1, 1994.

For dates of applicability of these regulations, see the discussion in the Dates of Applicability paragraph in the SUPPLEMENTARY INFORMATION portion of the preamble.

FOR FURTHER INFORMATION CONTACT: Jo Lynn Ricks of the Office of the Assistant Chief Counsel (Financial Institutions and Products), Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC 20224 (Attn: CC:DOM:FI&P). Telephone 202-622-3920 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1403. The estimated annual burden per recordkeeper varies from .1 to 10 hours, depending on individual circumstances, with an estimated average of .9 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

This document contains final regulations amending the Income Tax Regulations (26 CFR part 1) under section 1221 of the Internal Revenue Code (Code) (relating to the definition of capital asset). The provisions affected relate to the determination of the character of gain or loss from hedging transactions.

On October 20, 1993, temporary regulations (TD 8493) providing that gain or loss on most common business hedges is ordinary rather than capital were published in the *Federal Register* (58 FR 54037). A notice of proposed rulemaking (FI-46-93) cross-referencing the temporary regulations was published in the *Federal Register* for the same day (58 FR 54075). The regulations were intended to resolve questions that had arisen with respect to the tax treatment of business hedging following the decision of the United States Supreme Court in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988).

Many comments were received on the proposed regulations, and a public hearing was held on January 19, 1994. Most commentators supported the general approach of the proposed regulations, but a number suggested specific revisions to the proposed rules or the addition of rules to resolve remaining issues.

Explanation of Provisions

Paragraph (a) of § 1.1221-2 provides basic rules for the treatment of hedging transactions. Only minor, clarifying changes have been made to the proposed regulations.

Paragraph (a)(1) provides that property that is part of a hedging transaction, as defined in the regulations, is not a capital asset. Paragraph (a)(2) provides a similar rule for short sales and options. Where a short sale or option is part of a hedging transaction, as defined, any gain or loss on the short sale or option is ordinary. Final regulations under sections 1233 and 1234 provide that § 1.1221-2 governs the character of gain or loss on short sales and options that are part of hedging transactions.

Under paragraph (a)(3), if a transaction falls outside the regulations, gain or loss from the transaction is not made ordinary by the fact that property is a surrogate for a non-capital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

The provisions of this section generally apply to determine the character of gain or loss from transactions that also are subject to various international provisions of the Code. Paragraph (a)(4), however, provides that section 988 transactions are excluded from the character provisions of these regulations because gain or loss on those transactions is ordinary under section 988(a)(1). The regulations do apply to transactions that predate the effective date of section 988. Paragraph (a)(4) also provides that the definition of a hedging transaction under § 1.1221-2(b) does not apply for purposes of the hedging exceptions to the subpart F rules of section 954(c) and certain hedging rules in the interest allocation regulations under section 864(e). The IRS and Treasury are considering the possibility of using the definition of hedging transaction and other provisions of these regulations for purposes of various international tax provisions, except where a modification of the provisions is necessary to carry out the purposes of those international provisions. Comments on this subject are welcomed.

In defining the term hedging transaction, paragraph (b) of § 1.1221-2 retains the rule of the proposed regulations and adopts the concept of hedging in section 1256(e)(2)(A) of the Code. Under this rule, a hedging transaction generally is a transaction that a taxpayer enters into in the normal course of its business primarily to reduce the risk of interest rate or price changes or currency fluctuations.

A number of commentators suggested that the IRS abandon the rule of the proposed regulations and adopt a definition of hedging that looks to risk

management rather than risk reduction. This comment was not adopted because the IRS and Treasury believe that the definition in section 1256 represents the best indication of congressional intent with respect to business hedges. Although the risk reduction standard has been retained, the final regulations provide rules of application designed to ensure that the definition of hedging transaction is applied reasonably to include most common types of hedging transactions.

Paragraph (c)(1) deals with the meaning of risk reduction. To enter into a hedging transaction, the taxpayer must have risk when all of its operations are considered—that is, there must be risk on a “macro” basis. Nonetheless, a hedge of a single asset or liability, or pool of assets or liabilities, will be respected if the hedge reduces the risk attributable to the item or items being hedged and if the hedge is reasonably calculated to reduce the overall risk of the taxpayer’s operations. In addition, if a taxpayer hedges a particular asset or liability, or a pool of assets or liabilities, and the hedge is undertaken as part of a program to reduce the overall risk of the taxpayer’s operations, the taxpayer need not show that the hedge reduces its overall risk.

Paragraph (c)(1) also recognizes that fixed to floating hedges and certain types of written options may be risk reducing and may be used in hedging transactions. For example, a covered call with respect to assets held or a written put option with respect to assets to be acquired may reduce risk.

In addition, paragraph (c)(1) provides that a hedging transaction includes a transaction that is entered into primarily to reverse or counteract a hedging transaction. This rule recognizes that some transactions are used to eliminate some or all of the risk reduction accomplished through a hedging transaction. Although the transactions are not risk reducing if viewed independently, they are considered to be part of the larger hedging transaction.

Paragraph (c)(1) further provides that a taxpayer may hedge any part or all of its risk for any part of the period during which it has risk. The regulations also provide that the frequent entering into and termination of hedging positions is not relevant to whether transactions are hedging transactions.

Finally, paragraph (c)(1) provides that a transaction that is not entered into primarily to reduce risk is not a hedging transaction. For example, the so-called “store-on-the-board” transaction, in which a taxpayer disposes of its production and enters into a long futures or forward contract, is not a

hedging transaction because the long position does not reduce risk. Moreover, gain or loss on the contract is not made ordinary on the grounds that it is a surrogate for inventory.

The IRS and Treasury understand that there are situations in which a taxpayer engages in a store-on-the-board transaction as a hedge of an expected payment under an agricultural price support program. In this situation, a long futures or forward contract may qualify as a hedging transaction with respect to the expected payment.

Paragraph (c)(2) provides that a hedging transaction may be entered into by using a position that was a hedge of one asset or liability to hedge another asset or liability.

Paragraph (c)(3) provides that the acquisition of certain assets, such as investments, may not be a hedging transaction. Even though these assets may reduce risk, they typically are not acquired primarily to reduce risk. For example, a taxpayer's interest rate risk from a floating rate borrowing may be reduced by the purchase of debt instruments that bear a comparable floating rate. The acquisition of the debt instruments, however, is not made primarily to reduce risk and, therefore, is not a hedging transaction. Similarly, borrowings generally are not made primarily to reduce risk.

Paragraph (c)(4) defines the normal course requirement of paragraph (b) to include any transaction entered into in furtherance of a taxpayer's trade or business. Thus, for example, a liability hedge meets this requirement regardless of whether the liability is undertaken to fund current operations, an acquisition, or an expansion of a taxpayer's business. This definition does not apply to other uses of the term "normal course" in the Code or regulations.

Paragraph (c)(5) retains the rule in the proposed regulations that a hedge of property or of an obligation is a hedging transaction only if a sale or exchange of the property, or performance or termination of the obligation, could not produce capital gain or loss. In response to the many comments received, however, a special rule has been added for noninventory supplies. Under this rule, if a taxpayer sells only a negligible amount of a noninventory supply, then, only for purposes of determining whether a hedge of the purchase of that noninventory supply is a hedging transaction, the noninventory supply is treated as ordinary property. In this case, the Service and Treasury believe that the theoretical possibility of ordinary loss on a hedge and capital gain on the sale of supplies should not prevent the transactions from qualifying

as hedging transactions. The Service intends to issue guidance on the negligible amount standard. The comments received indicate that most taxpayers sell none of their supplies or a very small amount. Further comments are requested.

For prior years, a transition rule provides a substantially more generous standard for noninventory supplies. If, in each prior year that is open for assessment on September 1, 1994, a taxpayer sold no more than 15 percent of the greater of the total amount of a supply held at the beginning of the year or the total amount of the supply acquired in that year and meets certain other requirements, hedges of purchases of that supply are hedging transactions.

The final regulations do not provide a negligible sales rule for hedges of section 1231 assets. Sales of these assets are less predictable than sales of supplies and may occur many years after the transaction that hedges their purchase. The IRS and Treasury believe that it is inappropriate to provide ordinary treatment for the hedges when it is not known whether the assets will produce capital gains. Nonetheless, the regulations provide a special transition rule applicable to certain hedges of section 1231 assets entered into in prior years.

Paragraph (c)(6) provides that the status of liability hedges as hedging transactions is determined without regard to the use that is made of the proceeds of a borrowing. The IRS and Treasury believe that a liability hedge should not fail to qualify as a hedging transaction because the proceeds of the borrowing being hedged are used to purchase a capital asset.

Paragraph (c)(7) retains the rule in the proposed regulations that, in the case of hedges of aggregate risk, all but a de minimis amount of the risk being hedged must be attributable to ordinary property, ordinary obligations, and borrowings.

Although the purpose of the rules in paragraph (c) is to ensure that the definition of hedging transaction will be interpreted reasonably to cover most common business hedges, not all hedges are intended to be covered. For example, the regulations do not apply where a taxpayer hedges a dividend stream, the overall profitability of a business unit, or other business risks that do not relate directly to interest rate or price changes or currency fluctuations. Moreover, the regulations do not provide ordinary treatment for gain or loss from the disposition of stock where, for example, the stock is acquired to protect the goodwill or

business reputation of the acquirer or to ensure the availability of goods.

The status of so-called "gap" hedges is not separately addressed in paragraph (c). Insurance companies, for example, sometimes hedge the "gap" between their liabilities and the assets that fund them. Under the proposed regulations, a hedge of those assets does not qualify as a hedging transaction if the assets are capital. Commentators, therefore, suggested that the final regulations provide a rule that deems all gap hedges to be hedges of the liabilities rather than of the assets. The IRS and Treasury, however, are concerned that, where this type of hedge is more closely associated with the assets than the liabilities, there is a significant possibility of mismatch if the hedges are given ordinary treatment and the assets can be sold for capital gains. Thus, the final regulations do not include the suggested rule.

Whether a gap hedge qualifies as a liability hedge is a question of fact and depends on whether it is more closely associated with the liabilities than with the assets. For example, a contract to purchase assets is generally not a liability hedge even if the assets are being purchased to fund the liability. Other gap hedges may be appropriately treated as liability hedges and, therefore, may qualify as hedging transactions.

The IRS and Treasury understand that the most significant consequence of the failure of gap hedges to qualify as hedging transactions may be that they are then subject to the straddle rules of section 1092. Comments are requested on whether it would be appropriate to exempt these transactions from section 1092 and apply the hedge accounting rules of § 1.446-4 even though the transactions are not hedging transactions and their character is not determined under § 1.1221-2. The IRS and Treasury also note that there may be different considerations for determining whether income or loss from a gap hedge should be treated as an interest equivalent for purposes of international tax provisions, such as section 864(e). Comments are also requested on this point.

Paragraph (d) is reserved in the final regulations to allow development of rules applicable to hedging by members of a consolidated group. Proposed regulations on this subject are published in the Proposed Rules section of this issue of the *Federal Register*.

Paragraph (e)(1) retains the requirement of the proposed regulations that hedging transactions must be identified before the close of the day on which they are entered into. Paragraph (e)(2), however, relaxes the rule of the proposed regulations and requires that

the item, items, or aggregate risk being hedged be identified substantially contemporaneously with entering into the hedging transaction. The identification must be made no more than 35 days after entering into the hedging transaction. This time period should make it possible for taxpayers to identify the hedged item, items, or aggregate risk at the time they prepare monthly reports for nontax purposes.

Some commentators suggested eliminating entirely the requirement of identifying the item being hedged. The Service and Treasury believe, however, that this identification is needed to establish that the definition of hedging transaction is satisfied. Moreover, because special identification rules have been provided for hedges of aggregate risk and certain inventory hedges, the requirement of identifying the items being hedged should not be overly burdensome.

A transition rule is provided to extend the time period for identifying a transaction that is a hedging transaction under the final regulations and that the taxpayer reasonably treated as other than a hedging transaction under the proposed regulations. If such a transaction was entered into before October 1, 1994, and remains in existence on that date, the identification and recordkeeping requirements of paragraph (e) apply, except that the identification of both the hedging transaction and the hedged item are timely if made before the close of business on October 1, 1994. However, if the transaction was entered into before October 1, 1994, and does not remain in existence on that date, the identification and recordkeeping requirements of paragraph (e) do not apply.

Paragraph (e)(3) contains a series of special rules for identifying certain types of hedging transactions. In the case of inventory, the identification must specify the type or class of inventory to which the hedge relates. If particular inventory purchases or sales transactions are being hedged, the taxpayer must also identify the expected dates and the amounts to be acquired or sold. In the case of hedges of aggregate risk, the identification requirement is satisfied if a taxpayer's records contain a description of the hedging program and if the taxpayer establishes a system under which transactions are identified as being entered into as part of that program. The intent underlying this rule is to provide verifiable information with respect to the item being hedged without requiring the taxpayer to identify individually the many items

that give rise to the aggregate risk being hedged.

Paragraph (e)(4) generally retains and expands the rules of the proposed regulations with respect to how an identification is made. It must be clear that the identification is being made for tax purposes. In lieu of separately identifying each transaction, however, a taxpayer may establish a system in which identification is indicated by the type of transaction or the manner in which the transaction is consummated or recorded.

Paragraph (e)(5) is reserved to deal with the required identification where the taxpayer is a member of a consolidated group, and paragraph (e)(6) provides that an identification for purposes of section 1256(e)(2)(C) is also an identification for purposes of § 1.1221-2(e)(1).

Paragraph (f) deals with the effect of identification and non-identification and provides rules that generally are unchanged from the proposed regulations. The only significant change is the addition of a rule that allows correction of an inadvertent identification in some circumstances. If the correction is allowed, the transaction is not subject to the ordinary-gain, capital-loss rule that generally applies to transactions that are incorrectly identified as hedging transactions.

Final regulations under section 1256 retain the rules of the proposed regulations that coordinate the identification of hedges for purposes of section 1256(e). In addition, the regulations provide that, if a taxpayer inadvertently identifies a transaction as a hedging transaction and corrects it in accordance with paragraph (f)(1)(ii) of § 1.1221-2, the transaction is treated as if it were not identified as a hedging transaction for purposes of section 1256(e)(2)(C). Thus, section 1256(f)(1) does not impose ordinary-gain, capital-loss treatment on the transaction.

Dates of Applicability

Except for the identification rules of paragraph (e), which apply to transactions that were entered into on or after January 1, 1994, or were entered into before that date and remained in existence on March 31, 1994, these final regulations generally apply to all open taxable years. Taxpayers may, however, rely on any paragraph in § 1.1221-2T (26 CFR part 1 revised as of April 1, 1994), for transactions entered into prior to October 1, 1994, provided that the taxpayer applies the paragraph reasonably and consistently.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Jo Lynn Ricks, Office of Assistant Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. Effective July 18, 1984 the authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * * Section 1.1221-2 also issued under 26 U.S.C. 6001. * * *

Par. 2. Effective October 1, 1994, the authority citation for part 1 is further amended by removing the entry for § 1.1221-2T.

Par. 3. Effective July 18, 1994, § 1.1221-2 is added to read as follows:

§ 1.1221-2 Hedging transactions.

(a) *Treatment of hedging transactions—(1) In general.* This section governs the treatment of hedging transactions under section 1221. Except as provided in paragraph (f)(2) of this section (and notwithstanding the provisions of § 1.1221-1(a)), the term capital asset does not include property

that is part of a hedging transaction (as defined in paragraph (b) of this section).

(2) *Short sales and options.* This section also governs the character of gain or loss from a short sale or option that is part of a hedging transaction. See §§ 1.1233-2 and 1.1234-4. Except as provided in paragraph (f)(2) of this section, gain or loss on a short sale or option that is part of a hedging transaction (as defined in paragraph (b) of this section) is ordinary income or loss.

(3) *Exclusivity.* If a transaction is not a hedging transaction as defined in paragraph (b) of this section, gain or loss from the transaction is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

(4) *Coordination with other sections—*(i) *Section 988.* This section does not apply to determine the character of gain or loss realized on a section 988 transaction as defined in section 988(c)(1) or realized with respect to a qualified fund as defined in section 988(c)(1)(E)(iii). This section does apply, however, to transactions or payments that would be subject to section 988 but for the date that the transactions were entered into or the date that the payments were made.

(ii) *Sections 864(e) and 954(c).* Except as otherwise provided in regulations issued pursuant to sections 864(e) and 954(c), the definition of hedging transaction in paragraph (b) of this section does not apply for purposes of section 864(e) and 954(c).

(b) *Hedging transaction defined.* A hedging transaction is a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—

(1) To reduce risk of price changes or currency fluctuations with respect to ordinary property (as defined in paragraph (c)(5) of this section) that is held or to be held by the taxpayer; or

(2) To reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.

(c) *Rules of application.* The rules of this paragraph (c) apply for purposes of the definition of the term hedging transaction in paragraph (b) of this section. These rules must be interpreted reasonably and consistently with the purposes of this section. Where no specific rules of application control, the

definition of hedging transaction must be interpreted reasonably and consistently with the purposes of this section.

(1) *Reducing risk—*(i) *Transactions that reduce risk.* Whether a transaction reduces a taxpayer's risk is determined based on all of the facts and circumstances surrounding the taxpayer's business and the transaction. In general, a taxpayer's hedging strategies and policies as reflected in the taxpayer's minutes or other records are evidence of whether particular transactions reduce the taxpayer's risk.

(ii) *Micro and macro hedges—*(A) *In general.* A taxpayer has risk of a particular type only if it is at risk when all of its operations are considered. Nonetheless, a hedge of a particular asset or liability generally will be respected as reducing risk if it reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk of the taxpayer's operations. If a taxpayer hedges particular assets or liabilities, or groups of assets or liabilities, and the hedges are undertaken as part of a program that, as a whole, is reasonably expected to reduce the overall risk of the taxpayer's operations, the taxpayer generally does not have to demonstrate that each hedge that was entered into pursuant to the program reduces its overall risk.

(B) *Fixed-to-floating hedges.* Under the principles of paragraph (c)(1)(ii)(A) of this section, a transaction that economically converts an interest rate or price from a fixed price or rate to a floating price or rate may reduce risk. For example, if a taxpayer's income varies with interest rates, the taxpayer may be at risk if it has a fixed rate liability. Similarly, a taxpayer with a fixed cost for its inventory may be at risk if the price at which the inventory can be sold varies with a particular factor. Thus, a transaction that converts an interest rate or price from fixed to floating may be a hedging transaction.

(iii) *Written options.* A written option may reduce risk. For example, in appropriate circumstances, a written call option with respect to assets held by a taxpayer or a written put option with respect to assets to be acquired by a taxpayer may be a hedging transaction. See also paragraph (c)(1)(v) of this section.

(iv) *Extent of risk reduction.* A taxpayer may hedge all or any portion of its risk for all or any part of the period during which it is exposed to the risk.

(v) *Transactions that counteract hedging transactions.* If a transaction is entered into primarily to counteract all or any part of the risk reduction effected

by one or more hedging transactions, the transaction is a hedging transaction. For example, if a written option is used to reduce or eliminate the risk reduction obtained from another position such as a purchased option, then it may be part of a hedging transaction.

(vi) *Number of transactions.* The fact that a taxpayer frequently enters into and terminates positions (even if done on a daily or more frequent basis) is not relevant to whether these transactions are hedging transactions. Thus, for example, a taxpayer hedging the risk associated with an asset or liability may frequently establish and terminate positions that hedge that risk, depending on the extent the taxpayer wishes to be hedged. Similarly, if a taxpayer maintains its level of risk exposure by entering into and terminating a large number of transactions in a single day, its transactions may nonetheless qualify as hedging transactions.

(vii) *Transactions that do not reduce risk.* A transaction that is not entered into to reduce a taxpayer's risk is not a hedging transaction. For example, assume that a taxpayer produces a commodity for sale, sells the commodity, and enters into a long futures or forward contract in that commodity in the hope that the price will increase. Because the long position does not reduce risk, the transaction is not a hedging transaction. Moreover, gain or loss on the contract is not made ordinary on the grounds that it is a surrogate for inventory. See paragraph (a)(3) of this section.

(2) *Entering into a hedging transaction.* A taxpayer may enter into a hedging transaction by using a position that was a hedge of one asset or liability to hedge another asset or liability (recycling).

(3) *No investments as hedging transactions.* If an asset (such as an investment) is not acquired primarily to reduce risk, the purchase or sale of that asset is not a hedging transaction even if the terms of the asset limit or reduce the taxpayer's risk with respect to other assets or liabilities. For example, a taxpayer's interest rate risk from a floating rate borrowing may be reduced by the purchase of debt instruments that bear a comparable floating rate. The acquisition of the debt instruments, however, is not a hedging transaction because the transaction is not entered into primarily to reduce the taxpayer's risk. Similarly, borrowings generally are not made primarily to reduce risk.

(4) *Normal course.* Solely for purposes of paragraph (b) of this section, if a transaction is entered into in furtherance of a taxpayer's trade or

business, the transaction is entered into in the normal course of the taxpayer's trade or business. This rule applies even if the risk to be reduced relates to the expansion of an existing business or the acquisition of a new trade or business.

(5) *Ordinary property and obligations*—(i) *In general.* Except as provided in paragraph (g)(3) of this section (which contains transition rules), property is ordinary property to a taxpayer only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss regardless of the taxpayer's holding period when the sale or exchange occurs. Thus, for example, property used in a trade or business within the meaning of section 1231(b) (determined without regard to the holding period specified in that section) is not ordinary property. An obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce capital gain or loss. For purposes of the preceding sentence, termination has the same meaning as in section 1234A.

(ii) *Hedges of noninventory supplies.* Notwithstanding paragraph (c)(5)(i) of this section, if a taxpayer sells only a negligible amount of a noninventory supply, then, only for purposes of determining whether a transaction to hedge the purchase of that noninventory supply is a hedging transaction, the supply is treated as ordinary property. A noninventory supply is a supply that a taxpayer purchases for consumption in its trade or business and that is not an asset described in sections 1221(1) through (5).

(6) *Borrowings.* Whether hedges of a taxpayer's debt issuances (borrowings) are hedging transactions is determined without regard to the use of the proceeds of the borrowing.

(7) *Hedging an aggregate risk.* The term hedging transaction includes a transaction that reduces an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only if all of the risk, or all but a de minimis amount of the risk, is with respect to ordinary property, ordinary obligations, and borrowings.

(d) *Hedging by members of a consolidated group.* [Reserved].

(e) *Identification and recordkeeping*—(1) *Same-day identification of hedging transactions.* A taxpayer that enters into a hedging transaction (including recycling an existing hedge) must identify it as a hedging transaction. This identification must be made before the close of the day on which the taxpayer enters into the transaction.

(2) *Substantially contemporaneous identification of hedged item*—(i)

Content of the identification. A taxpayer that enters into a hedging transaction must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates. For example, if a taxpayer is hedging the price risk with respect to its June purchases of corn inventory, the transaction being hedged is the June purchase of corn and the risk is price movements in the market where the taxpayer buys its corn. For additional rules concerning the content of this identification, see paragraph (e)(3) of this section.

(ii) *Timing of the identification.* The identification required by this paragraph (e)(2) must be made substantially contemporaneously with entering into the hedging transaction. An identification is not substantially contemporaneous if it is made more than 35 days after entering into the hedging transaction.

(3) *Identification requirements for certain hedging transactions.* In the case of the hedging transactions described in this paragraph (e)(3), the identification under paragraph (e)(2) of this section must include the information specified.

(i) *Anticipatory asset hedges.* If the hedging transaction relates to the anticipated acquisition of assets by the taxpayer, the identification must include the expected date or dates of acquisition and the amounts expected to be acquired.

(ii) *Inventory hedges.* If the hedging transaction relates to the purchase or sale of inventory by the taxpayer, the identification is made by specifying the type or class of inventory to which the transaction relates. If the hedging transaction relates to specific purchases or sales, the identification must also include the expected dates of the purchases or sales and the amounts to be purchased or sold.

(iii) *Hedges of debt of the taxpayer*—(A) *Existing debt.* If the hedging transaction relates to accruals or payments under an issue of existing debt of the taxpayer, the identification must specify the issue and, if the hedge is for less than the full adjusted issue price or the full term of the debt, the amount and the term covered by the hedge.

(B) *Debt to be issued.* If the hedging transaction relates to the expected issuance of debt by the taxpayer or to accruals or payments under debt that is expected to be issued by the taxpayer, the identification must specify the following information: the expected date of issuance of the debt; the

expected maturity or maturities; the total expected issue price of the issue; and the expected interest provisions. If the hedge is for less than the entire expected issue price of the debt or the full expected term of the debt, the identification must also include the amount or the term being hedged. The identification may indicate a range of dates, terms, and amounts, rather than specific dates, terms, or amounts. For example, a taxpayer might identify a transaction as hedging the yield on an anticipated issuance of fixed rate debt during the second half of its fiscal year, with the anticipated amount of the debt between \$75 million and \$125 million, and an anticipated term of approximately 20 to 30 years.

(iv) *Hedges of aggregate risk*—(A) *Required identification.* If a transaction hedges aggregate risk as described in paragraph (c)(7) of this section, the identification under paragraph (e)(2) of this section must include a description of the risk being hedged and of the hedging program under which the hedging transaction was entered. This requirement may be met by placing in the taxpayer's records a description of the hedging program and by establishing a system under which individual transactions are identified as being entered into pursuant to the program.

(B) *Description of hedging program.* A description of a hedging program must include an identification of the type of risk being hedged, a description of the type of items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified. If the program contains controls on speculation (for example, position limits), the description of the hedging program must also explain how the controls are established, communicated, and implemented.

(4) *Manner of identification and records to be retained*—(i) *Inclusion of identification in tax records.* The identification required by this paragraph (e) must be made on, and retained as part of, the taxpayer's books and records.

(ii) *Presence or absence of identification must be unambiguous.* The presence or absence of an identification for purposes of this paragraph (e) must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer's books and records indicate that the identification is also being made for tax purposes. The taxpayer may indicate that individual hedging transactions, or

a class or classes of hedging transactions, that are identified for financial accounting or regulatory purposes are also being identified as hedging transactions for purposes of this section.

(iii) *Manner of identification.* The taxpayer may separately and explicitly make each identification, or, so long as paragraph (e)(4)(ii) of this section is satisfied, the taxpayer may establish a system pursuant to which the identification is indicated by the type of transaction or by the manner in which the transaction is consummated or recorded. An identification under this system is made at the later of the time that the system is established or the time that the transaction satisfies the terms of the system by being entered, or by being consummated or recorded, in the designated fashion.

(iv) *Examples.* The following examples illustrate the principles of paragraph (e)(4)(iii) of this section and assume that the other requirements of paragraph (e) of this section are satisfied.

(A) A taxpayer can make an identification by designating a hedging transaction for (or placing it in) an account that has been identified as containing only hedges of a specified item (or of specified items or specified aggregate risk).

(B) A taxpayer can make an identification by including and retaining in its books and records a statement that designates all future transactions in a specified derivative product as hedges of a specified item, items, or aggregate risk.

(C) A taxpayer can make an identification by placing a designated mark on a record of the transaction (for example, trading ticket, purchase order, or trade confirmation) or by using a designated form or a record that contains a designated legend.

(5) *Identification of hedges involving members of the same consolidated group.* [Reserved].

(6) *Consistency with section 1256(e)(2)(C).* Any identification for purposes of section 1256(e)(2)(C) is also an identification for purposes of paragraph (e)(1) of this section.

(f) *Effect of identification and non-identification—(1) Transactions identified—(i) In general.* If a taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (e)(1) of this section, the identification is binding with respect to gain, whether or not all of the requirements of paragraph (e) of this section are satisfied. Thus, gain from that transaction is ordinary income. If the transaction is not in fact a hedging

transaction described in paragraph (b) of this section, however, paragraphs (a)(1) and (a)(2) of this section do not apply and the character of loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose. Thus, the taxpayer's identification of the transaction as a hedging transaction does not itself make loss from the transaction ordinary.

(ii) *Inadvertent identification.* Notwithstanding paragraph (f)(1)(i) of this section, if the taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (e) of this section, the character of the gain is determined as if the transaction had not been identified as a hedging transaction if—

(A) The transaction is not a hedging transaction (as defined in paragraph (b) of this section);

(B) The identification of the transaction as a hedging transaction was due to inadvertent error; and

(C) All of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns in a manner consistent with the principles of this section.

(2) *Transactions not identified—(i) In general.* Except as provided in paragraphs (f)(2)(ii) and (iii) of this section, the absence of an identification that satisfies the requirements of paragraph (e)(1) of this section is binding and establishes that a transaction is not a hedging transaction. Thus, subject to the exceptions, the rules of paragraphs (a)(1) and (2) of this section do not apply, and the character of gain or loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose.

(ii) *Inadvertent error.* If a taxpayer does not make an identification that satisfies the requirements of paragraph (e) of this section, the taxpayer may treat gain or loss from the transaction as ordinary income or loss under paragraph (a)(1) or (a)(2) of this section if—

(A) The transaction is a hedging transaction (as defined in paragraph (b) of this section);

(B) The failure to identify the transaction was due to inadvertent error; and

(C) All of the taxpayer's hedging transactions in all open years are being treated on either original or, if necessary, amended returns as provided in paragraphs (a)(1) and (a)(2) of this section.

(iii) *Anti-abuse rule.* If a taxpayer does not make an identification that satisfies all the requirements of paragraph (e) of this section but the taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then gain from the transaction is ordinary. Thus, a taxpayer may not elect to treat gain or loss from a hedging transaction as capital gain or loss. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (b) of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

(3) *Transactions by members of a consolidated group.* [Reserved].

(g) *Effective dates and transition rules—(1) Effective date for identification requirements—(i) In general.* Paragraph (e) of this section applies to transactions that—

(A) Are entered into on or after January 1, 1994; or

(B) Are entered into before that date and remain in existence on March 31, 1994.

(ii) *Transition rule.* In the case of a hedging transaction that is entered into before January 1, 1994, and remains in existence on March 31, 1994, an identification is timely if it is made before the close of business on March 31, 1994.

(iii) *Special rules for hedging transactions not described in § 1.1221-2T(b).* In the case of a transaction that is entered into before October 1, 1994, that is a hedging transaction within the meaning of paragraph (b) of this section (or is treated as a hedging transaction under paragraph (g)(3) of this section), and that the taxpayer reasonably treated as not being a hedging transaction within the meaning of paragraph (b) of § 1.1221-2T (26 CFR part 1 revised as of April 1, 1994)—

(A) If the transaction does not remain in existence on October 1, 1994, paragraph (e) of this section does not apply; and

(B) If the transaction remains in existence on October 1, 1994, paragraph (e) of this section applies, and an identification is timely if it is made before the close of business on October 1, 1994.

(2) *Reliance on § 1.1221-2T—(i) General rule.* A taxpayer may rely on any paragraph in § 1.1221-2T (26 CFR part 1 revised as of April 1, 1994), for transactions entered into prior to October 1, 1994, provided that the

taxpayer applies the paragraph reasonably and consistently.

(ii) *Identification.* In the case of a transaction entered into before October 1, 1994, an identification is deemed to satisfy paragraph (e) of this section if it satisfies § 1.1221-2T(c) (26 CFR part 1 revised as of April 1, 1994). For this purpose, identification of the hedged item is timely if it is made within the period specified in paragraph (e)(2)(ii) of this section.

(3) *Transition rules for hedges of certain property—(i) Transition rule for section 1231 assets.* For all taxable years that ended prior to July 18, 1994 and that, as of September 1, 1994, were still open for assessment under section 6501, a taxpayer may treat as hedging transactions all transactions that were entered into during those years and that hedge property used in the trade or business within the meaning of section 1231(b) (a section 1231 asset) if the taxpayer can establish that, during those years—

(A) Sales of section 1231 assets did not give rise to net gain treated as capital gain (after application of section 1231(c));

(B) All of the hedges of section 1231 assets would be hedging transactions under paragraph (b) of this section if section 1231 assets were ordinary property; and

(C) On original or amended returns, the taxpayer consistently treats all of the hedges of section 1231 assets as hedging transactions.

(ii) *Transition rule for noninventory supplies.* For all taxable years that ended prior to July 18, 1994 and that, as of September 1, 1994, were still open for assessment under section 6501, a taxpayer may treat as hedging transactions all hedges of purchases of noninventory supplies (as defined in paragraph (c)(5)(ii) of this section) that would not otherwise qualify as hedging transactions and that were entered into during those years if the taxpayer can establish that, during those years—

(A) The taxpayer did not sell in any of those years more than 15 percent of the greater of the total amount of the supply held at the beginning of the year or the total amount of the supply acquired during that year;

(B) All of the hedges would be hedging transactions under paragraph (b) of this section if noninventory supplies were ordinary property; and

(C) On original or amended returns, the taxpayer consistently treats all of the hedges of noninventory supplies as hedging transactions.

(4) *Effective date for hedges by members of a consolidated group.* [Reserved].

§ 1.1221-2T [Removed]

Par. 4. Effective October 1, 1994, § 1.1221-2T is effectively removed.

Par. 5. Effective July 18, 1994 § 1.1233-2T is redesignated § 1.1233-2 and is revised to read as follows:

§ 1.1233-2 Hedging transactions.

The character of gain or loss on a short sale that is (or is identified as being) part of a hedging transaction is determined under the rules of § 1.1221-2.

Par. 6. Effective July 18, 1994 § 1.1234-4T is redesignated § 1.1234-4 and is revised to read as follows:

§ 1.1234-4 Hedging transactions.

The character of gain or loss on an acquired or a written option that is (or is identified as being) part of a hedging transaction is determined under the rules of § 1.1221-2.

Par. 7. Effective July 18, 1994 § 1.1256(e)-1 is added to read as follows:

§ 1.1256(e)-1 Identification of hedging transactions.

(a) *Identification and recordkeeping requirements.* Under section 1256(e)(2)(C), a taxpayer that enters into a hedging transaction must identify the transaction as a hedging transaction before the close of the day on which the taxpayer enters into the transaction.

(b) *Requirements for identification.* The identification of a hedging transaction for purposes of section 1256(e)(2)(C) must satisfy the requirements of § 1.1221-2(e)(1). Solely for purposes of section 1256(f)(1), however, an identification that does not satisfy all of the requirements of § 1.1221-2(e)(1) is nevertheless treated as an identification under section 1256(e)(2)(C).

(c) *Consistency with § 1.1221-2.* Any identification for purposes of § 1.1221-2(e)(1) is also an identification for purposes of this section. If a taxpayer satisfies the requirements of paragraph (f)(1)(ii) of § 1.1221-2, the transaction is treated as if it were not identified as a hedging transaction for purposes of section 1256(e)(2)(C).

(d) *Effective date.* This section applies to transactions entered into on or after October 1, 1994.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. Effective July 18, 1994 § 602.101(c) is amended by adding an

entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

CFR part or section where identified and described	Current OMB control number
1.1221-2	1545-1403

Par. 10. Effective October 1, 1994, in § 602.101(c), the entry for § 1.1221-2T(c) is removed.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: June 3, 1994.

Samuel Y. Sessions,
Acting Assistant Secretary of the Treasury.
[FR Doc. 94-16867 Filed 7-13-94; 9:10 am]
BILLING CODE 4830-01-U

DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Parts 90 and 91

Revitalizing Base Closure Communities and Community Assistance

AGENCY: Office of the Secretary of Defense, DoD.

ACTION: Interim final rule; notice of public hearing procedures.

SUMMARY: The Department of Defense published in the *Federal Register* on July 12, 1994 (59 FR 35463), plans to hold a public hearing to receive comments on the interim final rule regarding Revitalizing Base Closure Communities published in the *Federal Register* on April 6, 1994 (59 FR 16123). Individuals wishing to present oral testimony are requested to adhere to the following procedures. Due to time limitations, it is expected that approximately 30 will have the opportunity to testify. As a result, interested individuals are asked to call Ms. Jennifer Nuber Atkin on 703-697-5743 to reserve a time slot. All telephone reservations will be taken on a first come, first served basis with each slot consisting of five minutes. Only 20 reservations will be taken over the phone, the remaining time slots (approximately 10) will be assigned on the day of the hearing on a first come, first served basis beginning at 9 a.m. DoD will also be accepting written