(3) If you claim that any or all of the data or other information in your PBN is confidential, FDA will evaluate your claim. FDA will disclose the data or information in your PBN, unless FDA determines that your claim demonstrates that the criteria for exemption from disclosure in § 20.61 of this chapter are satisfied.

(4) If FDA determines that any or all of the data or other information in your PBN is confidential as of the date that we file it, those data or information would be available for public disclosure, in accordance with 20.61 of this chapter, when the criteria for exemption from disclosure in § 20.61 of this chapter are no longer satisfied.

(5) As long as the existence of your PBN is confidential, then the data or other information in your PBN would not be available for public disclosure.

(d) *How could the public obtain disclosable data and information in my PBN*? Under the FOIA, the public could obtain the disclosable data or other information in your PBN or an amendment to your PBN, or that you incorporate by reference into your PBN, by looking for these data and information in FDA's electronic reading room or by asking FDA to send them a copy of these data and information.

(e) *Would the agency's evaluation of my PBN be available to the public*?

FDA will make the following information easily accessible to the public (e.g., by placing the information on the Internet or in a paper or electronic file that is available at FDA for public review and copying):

(1) The text of any letter issued by the agency under § 192.30(c) of this chapter.

(2) The text of the agency's completed evaluation of any notice submitted under this part.

Dated: September 22, 2000.

Jane E. Henney,

Commissioner of Food and Drugs.

Donna E. Shalala,

Secretary of Health and Human Services.

[FR Doc. 01–1046 Filed 1–17–01; 8:45 am]

BILLING CODE 4160–01–F

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–107047–00]

RIN 1545–AY02

Hedging Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the character of hedging transactions. These proposed regulations reflect changes to the law made by the Ticket to Work and Work Incentives Improvement Act of 1999. The proposed regulations affect businesses entering into hedging transactions. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronically generated comments must be received by April 25, 2001. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for May 16, 2001, at 10 a.m., must be submitted by April 25, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–107047–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–107047–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS internet site at *http://www.irs.gov/tax_regs/regslist.html.* The public hearing will be held in the IRS auditorium, 1111 Constitution Ave., NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Jo Lynn Ricks, (202) 622–3920; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, contact Lanita Vandyke, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control numbers 1545–1403 and 1545–1480.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to 26 CFR part 1 under section 1221 of the Internal Revenue Code (Code). Prior to amendment in 1999, section 1221 generally defined a capital asset as property held by the taxpayer other than: (1) Stock in trade or other types of assets includible in inventory; (2) property used in a trade or business that is real property or property subject to depreciation; (3) certain copyrights (or similar property); (4) accounts or notes receivable acquired in the ordinary course of a trade or business; and (5) U.S. government publications.

In 1994, the IRS published in the **Federal Register** (59 FR 36360) final Treasury regulations under section 1221 providing for ordinary character treatment for most business hedges. The regulations generally apply to hedges that reduce risk with respect to ordinary property, ordinary obligations, and borrowings of the taxpayer and that meet certain identification requirements. (§ 1.1221–2). In 1996, the IRS published in the **Federal Register** (61 FR 517) final regulations on the character and timing of gain or loss from hedging transactions entered into by members of a consolidated group. The final regulations published in 1994 and 1996 are collectively referred to as the Treasury regulations in this preamble.

On December 17, 1999, section 1221 was amended by section 532 of the Ticket to Work and Work Incentives Improvement Act of 1999 (113 Stat. 1860) to provide ordinary gain or loss treatment for hedging transactions and consumable supplies. Section 1221(a)(7) provides ordinary treatment for hedging transactions that are clearly identified as such before the close of the day on which they were acquired, originated, or entered into.

The statute defines a hedging transaction generally to include a transaction entered into by the taxpayer in the normal course of business primarily to manage risk of interest rate, price changes, or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings of the taxpayer. § 1221(b)(2)(A)(i) and (ii). The statutory definition of hedging transaction also includes transactions to manage such other risks as the Secretary may prescribe in regulations. Section 1221(b)(2)(A)(iii). Further, the statute

grants the Secretary the authority to provide regulations to address the treatment of nonidentified or improperly identified hedging transactions, and hedging transactions involving related parties (sections 1221(b)(2)(B) and (b)(3), respectively). The statutory hedging provisions are effective for transactions entered into on or after December 17, 1999.

Section 1221(a)(8) provides that supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer's trade or business are not capital assets. That provision is effective for supplies held or acquired on or after December 17, 1999.

The legislative history to the hedging provisions states that Congress intended that the approach taken in the Treasury regulations with respect to the character of hedging transactions generally should be codified as an appropriate interpretation of present law. S. Rep. No. 201, 106th Cong., 1st Sess. 24 (1999). These proposed regulations conform the Treasury regulations to these statutory provisions.

Explanation of Provisions

Paragraph (a) of the proposed regulations provides basic rules for the treatment of hedging transactions. The substance of these rules is the same as the rules under § 1.1221–2(a).

Accordingly, paragraph (a)(1) of the proposed regulations generally provides that property that is part of a hedging transaction, as defined in section 1221(b)(2)(A) and paragraph (b) of the proposed regulations, is not a capital asset. Paragraph (a)(2) of the proposed regulations 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. 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. As under the Treasury regulations, Congress intended that the hedging rules be the exclusive means through which the gains and losses on hedging transactions are treated as ordinary. S. Rep. No. 201, 106th Cong., 1st Sess. 25 (1999).

The provisions of the proposed regulations 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) of the proposed regulations, however, provides that section 988 transactions are excluded from these regulations because gain or loss on those transactions is ordinary under section 988(a)(1). Paragraph (a)(4) of the proposed regulations also provides that the definition of a hedging transaction under § 1.1221–2(b) of the proposed regulations 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).

Regulations under § 1.482–8 will address risk management activities in the context of a global dealing operation. Thus, except to the extent provided in §§ 1.475(g)–2, 1.482–8, and 1.863–3(h), these regulations do not apply in determining the allocation and source of income for a participant in a global dealing operation or whether a risk management function related to the activities of a regular dealer in securities has been conducted.

Proposed regulations under §§ 1.882–5 and 1.884–1 also refer to hedging under § 1.1221–2 for purposes of determining assets and liabilities of a foreign corporation for interest allocation and branch tax purposes. The IRS and Treasury are evaluating the appropriate requirements necessary to implement cross-border and worldwide hedging rules for these purposes and seek comments in this regard. Therefore, paragraph (a)(4) of the proposed regulations provides that the definition of hedging transaction in paragraph (b) of the proposed regulations is inapplicable in determining the hedging requirements under sections 882(c) and 884, except to the extent provided in regulations under those sections.

Paragraph (b) of the proposed regulations restates the definition of hedging transaction in section 1221(b)(2)(A). Under this rule, a hedging transaction is generally a transaction that a taxpayer enters into in the normal course of its business primarily to manage the risk of interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings of the taxpayer.

Paragraph (c) of the proposed regulations provides rules of application designed to ensure that the definition of hedging transaction is applied reasonably to include most common types of business hedges. Congress intended that the approach taken in the Treasury regulations with respect to the character of hedging transactions generally should be codified as an appropriate interpretation of present law. S. Rep. No. 201, 106th Cong., 1st Sess. 24 (1999). The Senate Finance Committee believed that the Treasury regulations interpret risk reduction flexibly to provide hedging transaction treatment for fixed to floating hedges, certain written call options, dynamic hedges, partial hedges, recycled hedges, and hedges of aggregate risk (see § 1.1221–2(c)). *Id.* at n.12. The Committee believed that (depending on the facts) the treatment of those transactions as hedging transactions is appropriate and that it is also appropriate to modernize the definition of hedging transaction by providing risk management as the standard. *Id.* These proposed regulations revise the Treasury regulations to reflect the risk management standard.

Paragraph (c)(1) of the proposed regulations deals with the meaning of risk management. It provides that, except as otherwise provided in paragraph (c), a transaction satisfies the risk management standard if it reduces risk. 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 as managing risk 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) of the proposed regulations also recognizes that fixed to floating hedges and certain types of written options may manage risk and may be hedging transactions in appropriate situations. For example, a covered call with respect to assets held or a written put option with respect to assets to be acquired may be a hedging transaction.

In addition, paragraph (c)(1) of the proposed regulations provides that a hedging transaction includes a transaction that reverses or counteracts a hedging transaction. This rule recognizes that some transactions are used to eliminate some or all of the risk reduction accomplished through another 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) of the proposed regulations 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 proposed regulations also provide that the fact that a taxpayer frequently enters into and terminates hedging positions is not relevant to whether transactions are hedging transactions.

Except as otherwise provided in paragraph (c) of the proposed regulations, 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 output and enters into a long futures contract with respect to the same product, is not a hedging transaction. In this example, the long futures contact could be viewed as a surrogate for the storage of the commodity. The net proceeds from the sale of the production output and the gain or loss on the long futures contract simulates the price at which the production output would have sold if it had been physically stored and sold at a later time. However, because the production output to which the futures contract relates has been sold, there is no underlying position (with respect to ordinary property held or to be held) that exposes the taxpayer to price risk. Thus, the long position does not reduce risk. Moreover, gain or loss on the contract is not treated as ordinary on the grounds that it is a surrogate for inventory.

Paragraph (c)(2) of the proposed regulations 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) of the proposed regulations provides that the acquisition of certain assets, such as investments, may not be a hedging transaction. Even though acquisition of these assets may involve some risk reduction, they typically are not acquired primarily to manage 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 proposed regulations provide that 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 manage risk. The IRS and Treasury request comments on the circumstances in which the acquisition of debt instruments or borrowings are made primarily to manage 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) of the proposed regulations provides 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. The special rule in the Treasury regulations for noninventory supplies (§ 1.1221–2(c)(5)(ii)), however, is not contained in these proposed regulations. Under the noninventory supply 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, that noninventory supply is treated as ordinary property. This rule is not being proposed because section 1221(a)(8) generally provides ordinary gain or loss treatment for consumable supplies held or acquired on or after December 17, 1999.

Paragraph (c)(6) of the proposed regulations 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 so long as the transaction is entered into in furtherance of the taxpayer's trade or business. The Service 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) of the proposed regulations provides 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, or 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 with respect to ordinary property, ordinary obligations, or borrowings. 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.

Paragraph (c)(8) of the proposed regulations provides that a hedging transaction does not include a transaction entered into to manage risks other than interest rate or price changes, or currency fluctuations, unless a regulation, revenue ruling, or revenue procedure provides otherwise. Thus, until such guidance is published, a hedge of volume or revenue fluctuations is not a hedging transaction. One example of this type of hedge is a weather derivative used by an energy producer to hedge against the decrease in volume of sales from variations in weather patterns.

The IRS is considering whether to expand the definition of hedging transaction to include transactions that manage risks other than interest rate or price changes, or currency fluctuations with respect to ordinary property, ordinary obligations or borrowings of the taxpayer. The Service solicits comments on the types of risks that should be covered, including specific examples of derivative transactions that may be incorporated into future guidance.

The status of so-called ''gap'' hedges is not separately addressed in paragraph (c) of the proposed regulations. 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 assets. 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 rules in paragraphs (d), (e) and (f) of the proposed regulations, covering consolidated group hedging, identification and recordkeeping rules, and the effect of identification and non-identification, respectively, are generally unchanged from the corresponding rules in the Treasury regulations. This is because Congress generally intended to codify the approach to hedging transactions that was taken in the Treasury regulations. S.

Rep. No. 201, 106th Cong., 1st Sess. 24 (1999).

Paragraph (d) of the proposed regulations provides rules applicable to hedging by members of a consolidated group. The proposed regulations retain the single-entity approach of the Treasury regulations. That is, they treat the risk of one member of the group as the risk of the other members, as if all the members were divisions of a single corporation. Thus, a member of a consolidated group that hedges the risk of another member by entering into a transaction with a third party may receive ordinary gain or loss treatment on that transaction if the transaction otherwise qualifies as a hedging transaction.

Under this single-entity approach, intercompany transactions are neither hedging transactions nor hedged items. Because they are treated as transactions between divisions of a single corporation, intercompany transactions do not manage the risk of that single corporation and, therefore, fail to qualify as hedging transactions.

The proposed regulations also retain the separate-entity election of the Treasury regulations, permitting a consolidated group to treat its members as separate entities when applying the hedging rules. The election is made by attaching a statement to the group's federal income tax return.

For a group that elects separate-entity treatment, an intercompany transaction is treated as a hedging transaction if and only if: (1) It would qualify as a hedging transaction if entered into with an unrelated party; and (2) it is entered into with a member that, under its method of accounting, marks its position in the intercompany transaction to market. If these requirements are satisfied, the member with respect to which it is an intercompany hedging transaction must account for its position in the transaction under § 1.446–4, and, if that member properly identifies the transaction as a hedging transaction, each member treats the gain or loss from its position in the transaction as ordinary.

The proposed regulations provide that, even when these two requirements are met, these regulations supplant only the character and timing rules of § 1.1502–13. Other aspects of the transaction, such as the source of the gain or loss, are unaffected by these regulations and thus may be governed by other portions of § 1.1502–13.

Pursuant to section 1221(a)(7), paragraph (e)(1) of the proposed regulations provides that hedging transactions must be identified before the close of the day on which they are entered into. Paragraph (e)(2) of the proposed regulations 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.

Paragraph (e)(3) of the proposed regulations 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 date and the amount 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 there is a system for identifying transactions as 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) of the proposed regulations provides rules 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) of the proposed regulations deals with the required identification where the taxpayer is a member of a consolidated group, and paragraph (e)(6) of the proposed regulations provides that an identification for purposes of section 1256(e)(2) is also an identification for purposes of § 1.1221–2(e)(1).

Pursuant to section 1221(b)(2)(B), paragraph (f) of the proposed regulations deals with the effect of identification and non-identification. The rules in this paragraph are the same as the rules in paragraph (f) of the Treasury regulations.

The proposed regulations under section 1256 generally restate the rules of § 1.1256(e)–1 that coordinate the identification of hedges for purposes of section 1256(e). The citations to section 1256(e)(2)(C) in the Treasury regulations have been replaced with citations to section 1256(e)(2) in the proposed regulations.

Proposed Effective Date

The proposed regulations are proposed to be effective for transactions entered into on or after January 18, 2001. However, the IRS will not challenge any transaction entered into on or after December 17, 1999, and before January 18, 2001 that satisfies the provisions of these proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that very few small businesses enter into hedging transactions due to their cost and complexity. Further, those small businesses that hedge enter into very few hedging transactions because hedging transactions are costly, complex, and require constant monitoring and a sophisticated understanding of the capital markets. Therefore, a Regulatory Flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies of written comments) that are submitted timely (in the manner described in **ADDRESSES**) to the IRS. The IRS and Treasury request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 16, 2001, beginning at 10 a.m., in the IRS auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be

admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see **FOR FURTHER INFORMATION CONTACT.**

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 25, 2001. A period of 10 minutes will be allotted to each person making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Jo Lynn Ricks, Office of the Associate 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.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for § 1.1221 to read as follows:

Authority: 26 U.S.C. 7805 * * * § 1.1221–2 also issued under 26 U.S.C. 1221(b)(2)(A)(iii), (b)(2)(B), and (b)(3). * * *

Par. 2. Section 1.1221–2 is revised 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(a)(7). Except as provided in paragraph (f)(2) of this section, 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. 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 any qualified fund as defined in section 988(c)(1)(E)(iii).

(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 sections 864(e) and 954(c).

(iii) *Global dealing operation.* Except as otherwise provided in §§ 1.475(g)–2, 1.482–8, and 1.863–3(h), the rules of application for purposes of the definition of a hedging transaction in paragraph (c) of this section do not apply in determining the allocation and source of income with respect to a participant in a global dealing operation or in determining whether a risk management function related to the activities of a regular dealer in securities has been conducted. See § 1.482–8(a) for the definitions of global dealing operation, regular dealer in securities, and participant.

(iv) *Sections 882(c) and 884.* Except as otherwise provided in regulations issued under sections 882(c) and 884, the definition of hedging transaction in paragraph (b) of this section does not apply for purposes of those sections.

(b) *Hedging transaction defined.* Section 1221(b)(2)(A) provides that a hedging transaction is any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—

(1) To manage 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;

(2) To manage 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; or

(3) To manage such other risks as the Secretary may prescribe in regulations (see paragraph (c)(8) of this section).

(c) *Rules of application.* The rules of this paragraph (c) apply for purposes of the definition of the term hedging transaction in section 1221(b)(2)(A) and 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 section 1221(b)(2)(A) and this section.

(1) *Managing risk*—(i) *Transactions that manage risk.* Whether a transaction manages 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 were entered into primarily to manage 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 managing 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 rate or price to a floating rate or price may manage 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 manage 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 management.* 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 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 manage risk.* A transaction that is not entered into to reduce a taxpayer's risk does not manage risk. 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, and is not otherwise treated as a hedging transaction in this paragraph (c), 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 as a hedge of another asset or liability (recycling).

(3) *No investments as hedging transactions.* If an asset (such as an investment) is not acquired primarily to manage 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 manage 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 managed relates to the expansion of an existing business or the acquisition of a new trade or business.

(5) *Ordinary property and obligations.* 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.

(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 manages 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, or borrowings.

(8) *Hedges of other risks.* Except as otherwise determined in a regulation, revenue ruling, or revenue procedure, a hedging transaction does not include a transaction entered into to manage risks other than interest rate or price changes, or currency fluctuations.

(d) *Hedging by members of a consolidated group*—(1) *General rule: single-entity approach.* For purposes of this section, the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation. For example, if any member of a consolidated group hedges the risk of another member of the group by entering into a transaction with a third party, that transaction may potentially qualify as a hedging transaction. Conversely, intercompany transactions are not hedging transactions because, when considered as transactions between divisions of a single corporation, they do not manage the risk of that single corporation.

(2) *Separate-entity election.* In lieu of the single-entity approach specified in paragraph (d)(1) of this section, a consolidated group may elect separate-entity treatment of its hedging transactions. If a group makes this separate-entity election, the following rules apply.

(i) *Risk of one member not risk of other members.* Notwithstanding paragraph (d)(1) of this section, the risk of one member is not treated as the risk of other members.

(ii) *Intercompany transactions.* An intercompany transaction is a hedging transaction (an intercompany hedging transaction) with respect to a member of a consolidated group if and only if it meets the following requirements—

(A) The position of the member in the intercompany transaction would qualify as a hedging transaction with respect to the member (taking into account paragraph (d)(2)(i) of this section) if the member had entered into the transaction with an unrelated party; and

(B) The position of the other member (the marking member) in the transaction is marked to market under the marking member's method of accounting.

(iii) *Treatment of intercompany hedging transactions.* An intercompany hedging transaction (that is, a transaction that meets the requirements of paragraphs (d)(2)(ii)(A) and (B) of this section) is subject to the following rules—

(A) The character and timing rules of § 1.1502–13 do not apply to the income, deduction, gain, or loss from the intercompany hedging transaction; and

(B) Except as provided in paragraph (f)(3) of this section, the character of the marking member's gain or loss from the transaction is ordinary.

(iv) *Making and revoking the election.* Unless the Commissioner otherwise prescribes, the election described in this paragraph (d)(2) must be made in a separate statement saying ''[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF SECTION 1.1221–

2(d)(2) (THE SEPARATE-ENTITY APPROACH).'' The statement must also indicate the date as of which the election is to be effective. The election must be signed by the common parent and filed with the group's federal income tax return for the taxable year that includes the first date for which the election is to apply. The election applies to all transactions entered into on or after the date so indicated. The election may be revoked only with the consent of the Commissioner.

(3) *Definitions.* For definitions of consolidated group, divisions of a single corporation, group, intercompany transactions, and member, see section 1502 and the regulations thereunder.

(4) *Examples.* The following examples illustrate this paragraph (d):

General Facts. In these examples, *O* and *H* are members of the same consolidated group. *O*'s business operations give rise to interest rate risk ''*A*,'' which *O* wishes to hedge. *O* enters into an intercompany transaction with *H* that transfers the risk to *H*. *O*'s position in the intercompany transaction is ''*B*,'' and *H*'s position in the transaction is ''*C*.'' *H* enters into position ''*D*'' with a third party to reduce the interest rate risk it has with respect to its position *C*. *D* would be a hedging transaction with respect to risk *A* if *O*'s risk *A* were *H*'s risk.

Example 1. Single-entity treatment—(i) *General rule.* Under paragraph (d)(1) of this section, *O*'s risk *A* is treated as *H*'s risk, and therefore *D* is a hedging transaction with respect to risk *A*. Thus, the character of *D* is determined under the rules of this section, and the income, deduction, gain, or loss from *D* must be accounted for under a method of accounting that satisfies § 1.446–4. The intercompany transaction *B–C* is not a hedging transaction and is taken into account under § 1.1502–13.

(ii) *Identification. D* must be identified as a hedging transaction under paragraph (e)(1) of this section, and *A* must be identified as the hedged item under paragraph (e)(2) of this section. Under paragraph (e)(5) of this section, the identification of *A* as the hedged item can be accomplished by identifying the positions in the intercompany transaction as hedges or hedged items, as appropriate. Thus, substantially contemporaneous with entering into *D*, *H* may identify *C* as the hedged item and *O* may identify *B* as a hedge and *A* as the hedged item.

Example 2. Separate-entity election; counterparty that does not mark to market. In addition to the *General Facts* stated above, assume that the group makes a separate-entity election under paragraph (d)(2) of this section. If *H* does not mark *C* to market under its method of accounting, then *B* is not a hedging transaction, and the *B–C* intercompany transaction is taken into account under the rules of section 1502. *D* is not a hedging transaction with respect to *A*, but *D* may be a hedging transaction with respect to *C* if *C* is ordinary property or an ordinary obligation and if the other requirements of paragraph (b) of this section are met. If *D* is not part of a hedging transaction, then *D* may be part of a straddle for purposes of section 1092.

Example 3. Separate-entity election; counterparty that marks to market. The facts are the same as in *Example 2* above, except that *H* marks *C* to market under its method of accounting. Also assume that *B* would be a hedging transaction with respect to risk *A* if *O* had entered into that transaction with an unrelated party. Thus, for *O*, the *B–C* transaction is an intercompany hedging transaction with respect to *O*'s risk *A*, the character and timing rules of § 1.1502–13 do not apply to the *B–C* transaction, and *H*'s income, deduction, gain, or loss from *C* is ordinary. However, other attributes of the items from the *B–C* transaction are determined under § 1.1502–13. *D* is a hedging transaction with respect to *C* if it meets the requirements of paragraph (b) of this section.

(e) *Identification and recordkeeping*—(1) *Same-day identification of hedging transactions.* Under section 1221(a)(7), a taxpayer that enters into a hedging transaction (including recycling an existing hedging transaction) must clearly identify it as a hedging transaction before the close of the day on which the taxpayer acquired, originated, or entered into the transaction (or recycled the existing hedging 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 issue price or the full term of the debt, the amount of the issue price 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; 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 can be 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 of identification must be unambiguous.* The presence 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) 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 designating a certain mark, a certain form, or a certain legend as meaning that a transaction is a hedge of a specified item (or of specified items or a specified aggregate risk). Identification can be made by placing the designated mark on a record of the transaction (for example, trading ticket, purchase order, or trade confirmation) or by using the designated form or a record that contains the designated legend.

(5) *Identification of hedges involving members of the same consolidated group*—(i) *General rule: single-entity approach.* A member of a consolidated group must satisfy the requirements of this paragraph (e) as if all of the members of the group were divisions of a single corporation. Thus, the member entering into the hedging transaction with a third party must identify the hedging transaction under paragraph (e)(1) of this section. Under paragraph (e)(2) of this section, that member must also identify the item, items, or aggregate risk that is being hedged, even if the item, items, or aggregate risk relates primarily or entirely to other members of the group. If the members of a group use intercompany transactions to transfer risk within the group, the requirements of paragraph (e)(2) of this section may be met by identifying the intercompany transactions, and the risks hedged by the intercompany transactions, as hedges or hedged items, as appropriate. Because identification of the intercompany transaction as a hedge serves solely to identify the hedged item, the identification is timely if made within the period required by paragraph (e)(2) of this section. For example, if a member transfers risk in an intercompany transaction, it may identify under the rules of this paragraph (e) both its position in that transaction and the item, items, or aggregate risk being hedged. The member that hedges the risk outside the group may identify under the rules of this paragraph (e) both its position with the third party and its position in the intercompany transaction. Paragraph (d)(4) *Example 1* of this section illustrates this identification.

(ii) *Rule for consolidated groups making the separate-entity election.* If a consolidated group makes the separate-entity election under paragraph (d)(2) of this section, each member of the group must satisfy the requirements of this paragraph (e) as though it were not a member of a consolidated group.

(6) *Consistency with section 1256(e)(2).* Any identification for purposes of section 1256(e)(2) 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) 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 (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 (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 (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. 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*—(i) *Single-entity approach.* If a consolidated group is under the general rule of paragraph (d)(1) of this section (the single-entity approach), the rules of this paragraph (f) apply only to transactions that are not intercompany transactions.

(ii) *Separate-entity election.* If a consolidated group has made the election under paragraph (d)(2) of this section, then, in addition to the rules of paragraphs (f)(1) and (2) of this section, the following rules apply:

(A) If an intercompany transaction is identified as a hedging transaction but does not meet the requirements of paragraphs (d)(2)(ii)(A) and (B) of this section, then, notwithstanding any contrary provision in § 1.1502–13, each party to the transaction is subject to the rules of paragraph (f)(1) of this section with respect to the transaction as though it had incorrectly identified its position in the transaction as a hedging transaction.

(B) If a transaction meets the requirements of paragraphs (d)(2)(ii) (A) and (B) of this section but the transaction is not identified as a hedging transaction, each party to the transaction is subject to the rules of paragraph (f)(2) of this section. (Because the transaction is an intercompany hedging transaction, the character and timing rules of § 1.1502–13 do not apply. See paragraph (d)(2)(iii)(A) of this section.)

(g) *Effective date.* The rules of this section apply to transactions entered into on or after January 18, 2001.

Par. 2. Section 1.1256(e)–1 is revised to read as follows:

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

(a) *Identification and recordkeeping requirements.* Under section 1256(e)(2), 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) 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) *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 § 1.1221–2(f)(1)(ii), the transaction is treated as if it were not identified as a hedging transaction for purposes of section 1256(e)(2).

(d) *Effective date.* This section applies to transactions entered into on or after January 18, 2001.

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

[FR Doc. 01–491 Filed 1–17–01; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–105801–00]

RIN 1545–AX92

Capitalization of Interest and Carrying Charges Properly Allocable to Straddles

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that clarify the application of the straddle rules to a variety of financial instruments. The proposed regulations clarify what constitutes interest and carrying charges and when interest and carrying charges are properly allocable to personal property that is part of a straddle. The proposed regulations also clarify that a taxpayer's obligation under a debt instrument can be a position in personal property that is part of a straddle. The proposed regulations provide guidance to taxpayers that enter into straddle transactions. This document provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments and requests to appear and outlines of topics to be discussed at the public hearing scheduled for May 22, 2001, at 10 a.m., must be submitted by May 1, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–105801–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–105801–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax__regs/regslist.html. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Kenneth Christman (202) 622–3950; concerning submission and delivery of comments and the public hearing, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Sections 501 and 502 of the Economic Recovery Tax Act of 1981 (Pub. L. 97–34, 95 Stat. 172) added sections 1092 and 263(g), respectively, to the Internal Revenue Code to address certain deferral and conversion strategies involving economically offsetting positions in actively traded personal property. These economically offsetting positions are called straddles. Section 1092(c)(1).

In general, under section 1092, a taxpayer that realizes a loss on a position in actively traded personal property must defer the recognition of the loss to the extent the taxpayer has unrecognized gain on an economically offsetting position in the property. This deferral rule matches the recognition of loss with the recognition of the economically offsetting income. Section 263(g) addresses interest and carrying charges properly allocable to personal property that is part of a straddle. Under this section, these otherwise deductible expenses are not currently deductible. Instead, they must be capitalized into the basis of the property. By requiring capitalization, section 263(g) prevents: (1) A taxpayer from gaining a timing advantage by accruing deductions associated with carrying the straddle transaction before recognizing income from a position in personal property that is part of the straddle; and (2) the deductions from having a character different from that of the income.

These proposed regulations provide certain rules with respect to the application of section 263(g) and section 1092.

Explanation of Provisions

The proposed regulations consist of § 1.263(g)–1, which provides a general introduction, and §§ 1.263(g)–2, 1.263(g)–3, 1.263(g)–4, and 1.263(g)–5, described below. The proposed regulations also include a new paragraph 1.1092(d)–1(d).

The proposed regulations generally address four issues: (1) The definition of *personal property* as such term is used in section 263(g) (in § 1.263(g)–2); (2) the type of payments that are subject to the capitalization rules of section 263(g) (in § 1.263(g)–3); (3) the operation of the capitalization rules of section 263(g) (in § 1.263(g)–4); and (4) the circumstances under which an issuer's obligation under a debt instrument can be a position in actively traded personal property and, therefore, part of a straddle (in § 1.1092(d)–1(d)). These issues are discussed in more detail below.

Definition of the Term Personal Property for Purposes of Section 263(g)

Section 263(g)(1) requires capitalization of interest and carrying charges properly allocable to personal property that is part of a straddle (as defined in section 1092(c)). Section 1092(d)(1) defines personal property for purposes of section 1092, as personal property of a type that is actively traded. Commentators have suggested that because sections 263(g) and 1092 were enacted at the same time, the term *personal property* as used in section 263(g) should be given the same definition under section 1092(d)(1). This would limit the definition of personal property in section 263(g) to personal property of a type that is actively traded.

Despite this suggestion, the proposed regulations provide that personal property has its common law meaning in section 263(g) for two reasons. First, the definition in section 1092(d)(1) by its terms applies only for purposes of section 1092. Second, the broader, common law interpretation of personal property more closely accords with the purposes of section 263(g). Application of the limited definition in section