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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD ]

RIN 1545-AY02

Hedging Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the character of gain or loss from hedging transactions. The regulations reflect changes to the law made by the Ticket to Work and Work Incentives Improvement Act of 1999. The regulations affect businesses entering into hedging transactions.

DATES: Effective Date: These regulations are effective [**INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER**].

Applicability Dates: 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: Elizabeth Handler, (202) 622-3930 or Viva Hammer at (202) 622-0869 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Paperwork Reduction Act**

The collections of information contained in these final regulations have 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 number 1545-1480. Some responses to these collections of information are mandatory, and others are required to obtain the benefit of the separate-entity election.

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.

The estimated annual burden per respondent or recordkeeper varies from .1 to 40 hours, depending on individual circumstances, with an estimated average of 5.9 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, W:CAR:MP:FP:S, 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.

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 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 certain business hedges. The regulations generally apply to transactions 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. In this preamble, the final regulations published in 1994 and 1996 are referred to collectively as the Treasury regulations.

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 as 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. Sections

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. Congress intended that the hedging rules be the exclusive means through which the gains and losses from hedging transactions are treated as ordinary. S. Rep. No. 201, 106<sup>th</sup> Cong., 1st Sess. 25 (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.

A notice of proposed rulemaking (REG-107047-00, 2001-14 I.R.B. 1002) was published in the **Federal Register** (66 FR 4738) on January 18, 2001. On May 16, 2001, the IRS held a public hearing on the proposed regulations. Written comments responding to the notice of proposed rulemaking were also received. In response to these comments, the proposed regulations were modified and as so modified are adopted as final regulations. The principal changes to the proposed regulations are discussed below.

## **Explanation of Provisions**

### Coordination with International Provisions of the Code

\_\_\_\_\_The provisions of these regulations generally apply to determine the character of gain or loss from transactions that are also subject to various international provisions of the Code. Paragraph (a)(4) of the regulations, however, provides that the character of gain or loss on section 988 transactions is not determined under these regulations because gain or loss on those transactions is ordinary under section 988(a)(1). In addition, no implication is intended as to what constitutes "risk management" or "managing risk" for purposes of proposed or final regulations under section 482.

Paragraph (a)(4) of the proposed regulations provided that the definition of a hedging transaction under §1.1221-2(b) of the proposed regulations would apply for purposes of certain other international provisions of the Code only to the extent provided in regulations issued under those provisions. Technical changes have been made in the final regulations to eliminate references to proposed regulations as well as Code sections for which the relevant regulations have not been issued in final form. Subsequent regulations will specify the extent to which the rules relating to hedging transactions that are contained in §1.1221-2 will be applicable for purposes of those other regulations and related Code sections.

### Risk Management Standard

\_\_\_\_\_Several commentators noted that the proposed regulations used risk reduction as the operating standard to implement the

risk management definition of hedging introduced by section 1221(b)(2)(A). These commentators found that risk reduction is too narrow a standard to encompass the intent of Congress which defined hedges to include transactions that manage risk of interest rate, price changes or currency fluctuations. They urged the IRS and Treasury to adopt a broader definition of hedging to reflect Congress' intent. With one exception, the commentators did not suggest a definition of risk management.

In response to these comments, the final regulations have been restructured to implement the risk management standard. No definition of risk management is provided, but instead, the rules characterize a variety of classes of transactions as hedging transactions because they manage risk. Risk reducing transactions still qualify as one class of hedging transactions, but there are also others. In addition, specific provision is made for the recognition of additional types of qualifying risk management transactions through published guidance or private letter rulings. Under the final regulations, as under the proposed regulations, transactions entered into for speculative purposes will not qualify as hedging transactions. See S. Rep. No. 201, 106<sup>th</sup> Cong., 1<sup>st</sup> Sess. 24 (1999).

#### Application on the Basis of Separate Business Units

\_\_\_\_\_The proposed regulations provided that a taxpayer has risk of a particular type only if it is at risk when all of its operations are considered. That is, risk must exist on a "macro" basis. For this purpose, under the proposed regulations, a taxpayer has to show that hedges of particular

assets or liabilities, or groups of assets or liabilities, are reasonably expected to reduce the overall risk of the taxpayer's operations.

Commentators pointed out that this entity-based approach to hedging is no longer uniform business practice. Instead, businesses often conduct risk management on a business unit by business unit basis. In response to these comments, the final regulations permit the determination of whether a transaction manages risk to be made on a business unit basis provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. An example was added to the final regulations in which for one taxpayer, the determination of whether hedging activities reduce risk is made at the business unit level. In the example, the conduct of risk management activities within separate business units is undertaken as part of a program to reduce the overall risk of the taxpayer's operations.

#### Fixed-to-floating Interest Rate Hedges

\_\_\_\_ Paragraph (c)(1) of the proposed regulations recognized that 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. Commentators suggested that the rule in the proposed regulations provides insufficient guidance in that it states only that fixed-to-floating interest rate or price hedges may be hedging transactions. In response to these comments, the regulations have been restructured to separately address interest rate hedges and price hedges.

Commentators suggested that in the case of interest rate conversions, a taxpayer may choose to convert from a floating to a fixed rate to fix the amount payable on the obligation. However, a taxpayer could also elect to convert from a fixed to a floating rate to insure that the value of the liability remained relatively constant. In response to these comments, the final regulations provide that a transaction that converts an interest rate from a fixed rate to a floating rate or from a floating rate to a fixed rate manages risk. With respect to fixed-to-floating price hedges, the final regulations adopt the proposed rules without change.

#### Transactions Not Entered into Primarily to Manage Risk

\_\_\_\_ Paragraph (c)(3) of the proposed regulations provided that the purchase or sale of certain assets will not qualify as a hedging transaction if the assets are not acquired primarily to manage risk. This rule was illustrated by the example of a taxpayer that has an interest rate risk from a floating rate borrowing and that acquires debt instruments bearing a comparable floating interest rate. Although the taxpayer's interest rate risk from the floating rate borrowing may be reduced by the purchase of the floating rate debt instruments, the proposed regulations provided that the acquisition of the debt instruments is not made primarily to reduce risk and, therefore, is not a hedging transaction.

The IRS and Treasury understand that some employers may invest in assets (such as shares of a mutual fund) that are used as a reference investment for purposes of computing their

liability to employees under a nonqualified deferred compensation plan. A question may arise whether such an investment may constitute a hedging transaction and, if so, whether income from the investment may be deferred by the employer until payments of deferred compensation are made to employees. See §1.446-4(b); but compare Albertson's, Inc. v. Commissioner, 42 F.3d 537 (9<sup>th</sup> Cir. 1994).

The rule in the proposed regulations is based on §1.1221-2(c)(1)(vii). The rule has been restated in the final regulations to refer specifically to investments in debt instruments, equity securities, and annuity contracts so as to provide greater certainty in its application. For this purpose certain transactions in instruments that are not themselves debt instruments may include a debt investment. See, e.g., §1.446-3(g)(4). Further, the final regulations provide that the IRS may identify by future published guidance specified transactions that are determined not to be entered into primarily to manage risk. An example has been added to the final regulations to illustrate that an investment in mutual fund shares in the case described in the preceding paragraph does not qualify as a hedging transaction. A similar example is added with respect to an investment in an annuity contract.

Hedging Risks Other Than Interest Rate or Price Changes, or Currency Fluctuations

\_\_\_\_ Paragraph (c)(8) of the proposed regulations provided that the Commissioner may, by published guidance, provide that hedging transactions include transactions entered into to manage

risks other than interest rate or price changes, or currency fluctuations.

The notice of proposed rulemaking solicited comments regarding the expansion of the definition of hedging transactions 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. Some comments were received in response to that request. Because the comments described hedging transactions that related to the general operating results of a business (such as gross sales) rather than specific ordinary property, ordinary obligations or borrowings of the taxpayer, the implementation of rules respecting such hedges would present a number of issues not easily dealt with by the rules contained in the final regulations. Thus, the expansion of the scope of operation of the hedging rules is not being proposed at this time, so as not to delay the publication of guidance on the matters that are covered by the final regulations. However, the IRS is continuing to consider whether to expand the definition of hedging transactions to cover hedges of such other risks. The IRS and Treasury invite comments on the types of risks that should be covered, including specific examples of derivative transactions that may be incorporated into future guidance, as well as the appropriate timing of inclusion of gains and losses with respect to such transactions. Send submissions to: CC:ITA:RU (REG-107047-00), room 5226,

Internal Revenue Service, POB 7604, Ben Franklin Station,  
Washington, DC 20044.

#### "Gap" Hedges

\_\_\_\_\_The status of so-called gap hedges was not separately addressed in the proposed regulations and is not covered in the final regulations. Insurance companies, for example, sometimes hedge the gap between their liabilities and the assets that fund them. Under the final regulations, a hedge of those assets would 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.

#### Identification Requirement

\_\_\_\_\_A rule has been added specifying additional information that must be provided for a transaction that counteracts a hedging transaction.

#### Dates of Applicability

\_\_\_\_\_The regulations generally apply to all transactions entered into on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. However, the IRS will not challenge any transaction entered into on or after December 17, 1999, and before **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, that satisfies the provisions of either §1.1221-2 of REG-107047-00, published in the **Federal Register** (66 FR 4738) on January 18, 2001, or the provisions of this final regulation.

#### **Special Analyses**

It has been determined that this Treasury decision 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 Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Drafting Information**

The principal author of these regulations is Elizabeth Handler, 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.

### **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 is amended by revising the entry for §1.1221-2 to read as follows:

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

Section 1.1221-2 also issued under 26 U.S.C. 1221(b)(2)(A)(iii), (b)(2)(B), and (b)(3); 1502 and 6001. \* \* \*

Par. 2. In the list below, for each location indicated in the left column, remove the language in the middle column from that section, and add the language in the right column.

Affected section	Remove	Add
1.446-4(d)(2), first sentence	1.1221-2(e)	1.1221-2(f)
1.446-4(d)(2), last sentence	1.1221-2(e)(2)	1.1221-2(f)(2)
1.446-4(d)(3), first sentence	1.1221-2(e)	1.1221-2(f)
1.446-4(d)(3), last sentence	1.1221-2(a)(4)(i)	1.1221-2(a)(4)
1.446-4(e)(7), first sentence	1.1221-2(c)(2)	1.1221-2(d)(4)
1.446-4(e)(9)(ii), first sentence	1.1221-2(d)(2)	1.1221-2(e)(2)
1.446-4(e)(9)(ii), last sentence	1.1221-2(d)(2)(ii)	1.1221-2(e)(2)(ii)

1.475(b)-1(d)(2)	1.1221-2(e)	1.1221-2(f)
1.954-2(a)(4)(ii)(A), first sentence	1.1221-2(a) through (c)	1.1221-2(a) through (d)
1.954-2(a)(4)(ii)(B), first sentence	1.1221-2(e)	1.1221-2(f)
1.954-2(g)(2)(ii)(B)(2), last sentence	1.1221-2(c)(7)	1.1221-2(c)(3)
1.954-2(g)(3)(i)(B), last sentence	1.1221-2(c)(7)	1.1221-2(c)(3)
1.1256(e)-1(b), first and last sentences	1.1221-2(e)(1)	1.1221-2(f)(1)
1.1256(e)-1(c), first sentence	1.1221-2(e)(1)	1.1221-2(f)(1)
1.1256(e)-1(c), last sentence	paragraph (f)(1)(ii) of §1.1221-2	paragraph (g)(1)(ii) of §1.1221-2

Par. 3. 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 (g)(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 (g)(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 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).

(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)(2) 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 (d)(6) of this section).

(c) General rules--(1) 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 includes managing risks relating to the expansion of an existing business or the acquisition of a new trade or business.

(2) 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 under any circumstances. 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 this paragraph (c)(2), the term termination has the same meaning as it does in section 1234A.

(3) 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.

(4) Managing risk--(i) In general. 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. Whether a transaction manages a taxpayer's risk may be determined on a business unit by business unit basis (for example by treating particular groups of activities, including the assets and liabilities attributable to those activities, as separate business units), provided that the business unit is within a single entity or consolidated return group that adopts the single-entity approach. 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) Limitation of risk management transactions to those specifically described. Except as otherwise determined by published guidance or by private letter ruling, a transaction that is not treated as a hedging transaction under paragraph (d) does not manage risk. Moreover, a transaction undertaken for speculative purposes will not be treated as a hedging transaction.

(d) Transactions that manage risk--(1) Risk reduction transactions--(i) In general. A transaction that is entered into to reduce a taxpayer's risk, manages a taxpayer's risk.

(ii) Micro and macro hedges--(A) In general. A taxpayer generally 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) Example. The following example illustrates the rules stated in paragraph (d)(1)(ii)(A) of this section:

Example. Corporation X manages its business operations by treating particular groups of activities, including the assets and liabilities attributable to those assets, as separate business units. A separate set of books and records is maintained with respect to the activities, assets and liabilities of separate business unit y. As part of a risk management program that Corporation X reasonably expects to reduce the overall risks of its business operations, Corporation X enters into hedges to reduce the risks of separate business unit y. Corporation X may demonstrate that the hedges reduce risk by taking into account only the activities, assets and liabilities of business unit y.

(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 (d)(3) of this section.

(iv) Fixed-to-floating price hedges. Under the principles of paragraph (d)(1)(ii)(A) of this section, a transaction that economically converts a price from a fixed price to a floating price may reduce risk. For example, 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, for such a taxpayer a transaction that converts its fixed price to a floating price may be a hedging transaction.

(2) Interest rate conversions. A transaction that economically converts an interest rate from a fixed rate to a floating rate or that converts an interest rate from a floating rate to a fixed rate manages risk.

(3) Transactions that counteract hedging transactions. If a transaction is entered into primarily to offset all or any part of the risk management 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.

(4) Recycling. 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).

(5) Transactions not entered into primarily to manage risk--(i) Rule. Except as otherwise determined in published guidance or private letter ruling, the purchase or sale of a debt instrument, an equity security, or an annuity contract is not a hedging transaction even if the transaction limits or

reduces the taxpayer's risk with respect to ordinary property, borrowings, or ordinary obligations. In addition, the Commissioner may determine in published guidance that other transactions are not hedging transactions.

(ii) Examples. The following examples illustrate the rule stated in paragraph (d)(5)(i):

Example 1. Taxpayer borrows money and agrees to pay a floating rate of interest. Taxpayer purchases debt instruments that bear a comparable floating rate. Although taxpayer's interest rate risk from the floating rate borrowing may be reduced by the purchase of the debt instruments, the acquisition of the debt instruments is not a hedging transaction, because the transaction is not entered into primarily to manage the taxpayer's risk.

Example 2. Taxpayer undertakes obligations to pay compensation in the future. The amount of the future compensation payments is adjusted as if amounts were invested in a specified mutual fund and were increased or decreased by the earnings, gains and losses that would result from such an investment. Taxpayer invests funds in the shares of the mutual fund. Although the investment in shares of the mutual fund reduces the taxpayer's risk of fluctuation in the amount of its obligation to employees, the investment was not made primarily to manage the taxpayer's risk. Accordingly, the transaction is not a hedging transaction.

Example 3. Taxpayer provides a nonqualified retirement plan for employees that is structured like a defined

contribution plan. Based on a schedule that takes into account an employee's monthly salary and years of service with the taxpayer, the taxpayer makes monthly credits to an account for each employee. Each employee may designate that the account will be treated as if it were used to pay premiums on a variable annuity contract issued by the M insurance company with a value that reflects a specified investment option. M offers a number of investment options for its variable annuity contracts. Taxpayer invests funds in M company variable annuity contracts that parallel the investment options selected by the employees. The investment is not made primarily to manage the taxpayer's risk and is not a hedging transaction.

(6) Hedges of other risks. The Commissioner may, by published guidance, determine that hedging transactions include transactions entered into to manage risks other than interest rate or price changes, or currency fluctuations.

(7) Miscellaneous provision--(i) 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.

(ii) 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.

(e) 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 (e)(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 (e)(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 (e)(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 (e)(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 (g)(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 (e)(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(e)(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. 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. The following examples illustrate this paragraph (e):

Example 1. Single-entity treatment--(i) General rule. Under paragraph (e)(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 (f)(1) of this section, and A must be identified as the hedged item under paragraph (f)(2) of this section. Under paragraph (f)(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 (e)(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.

(f) 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 (f)(3) of this section.

(ii) Timing of the identification. The identification required by this paragraph (f)(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 (f)(3), the identification under paragraph (f)(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)(3) of this section, the identification under paragraph (f)(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.

(v) Transactions that counteract hedging transactions. If the hedging transaction is described in paragraph (d)(3) of this section, the description of the hedging transaction must include an identification of the risk management transaction that is being offset and the original underlying hedged item.

(4) Manner of identification and records to be retained--

(i) Inclusion of identification in tax records. The identification required by this paragraph (f) 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 (f) 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 (f)(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) Principles of paragraph (f)(4)(iii) of this section illustrated. Paragraphs (f)(4)(iv)(A) through (C) of this section illustrate the principles of paragraph (f)(4)(iii) of this section and assume that the other requirements of this paragraph (f) 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 (f) 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 (f)(1) of this section. Under paragraph (f)(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 (f)(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 (f)(2) of this section. For example, if a member transfers risk in an intercompany transaction, it may identify under the rules of this paragraph (f) 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 (f) both its position with the third party and its position in the intercompany transaction. Paragraph (e)(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 (e)(2) of this section, each member of the group must satisfy the requirements of this paragraph (f) 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 (f)(1) of this section.

(g) 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 (f)(1) of this section, the identification is binding with respect to gain, whether or not all of the requirements of paragraph (f) 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 (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 (g)(1)(i) of this section, if the taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (f) 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 (g)(2)(ii) and (iii) of this section, the absence of an identification that satisfies the requirements of paragraph (f)(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 (f) 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 (f) 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 (e)(1) of this section (the single-entity approach), the rules of this paragraph (g) apply only to transactions that are not intercompany transactions.

(ii) Separate-entity election. If a consolidated group has made the election under paragraph (e)(2) of this section, then, in addition to the rules of paragraphs (g)(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 (e)(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 (g)(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 (e)(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 (g)(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 (e)(2)(iii)(A) of this section.)

(h) Effective date. The rules of this section apply to transactions entered into on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Par. 4. 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(f)(1). Solely for purposes of section 1256(f)(1), however, an identification that does not satisfy all of the requirements of §1.1221-2(f)(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(f)(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. The rules of this section apply to transactions entered into on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

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. In §602.101, paragraph (b) is amended by removing the entries for "1.1221-2," "1.1221-2(d)(2)(iv)," "1.1221-2(e)(5)," "1.1221-2(g)(5)(ii)," "1.1221-2(g)(6)(ii)," "1.1221-2(g)(6)(iii)," and "1.1221-2T(c)" and adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

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(b) \* \* \*

CFR part or section where identified and described	OMB	Current control No.
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1.1221-2.....		1545-1480
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Deputy Commissioner of Internal Revenue.

Approved:

Assistant Secretary of the Treasury.