under the administrative control of a taxpayer, such as a corporate executive, shall be deemed to have been prepared or produced for him whether or not such letter, memorandum, or similar property is reviewed by him.

(4) For the application of section 1231 to the sale or exchange of property to which this paragraph applies, see §1.1231–1. For the application of section 170 to the charitable contribution of property to which this paragraph applies, see section 170(e) and the regulations thereunder.

(d) Section 1221(4) excludes from the definition of *capital asset* accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

(e) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term *capital assets*. An obligation may be issued on a discount basis even though the price paid exceeds the face amount. Thus, although the Second Liberty Bond Act (31 U.S.C. 754) provides that United States Treasury bills shall be issued on a discount basis, the issuing price paid for a particular bill may, by reason of competitive bidding, actually exceed the face amount of the bill. Since the obligations of the type described in this paragraph are excluded from the term *capital assets*, gains or losses from the sale or exchange of such obligations are not subject to the limitations provided in such subchapter P. It is, therefore, not necessary for a taxpayer (other than a life insurance company taxable under part I (section 801 and following), subchapter L, chapter 1 of the Code, as amended by the Life Insurance Company Tax Act of 1955 (70 Stat. 36), and, in the case of taxable years beginning before January 1, 1955, subject to taxation only on interest, dividends, and rents) to segregate the original discount accrued and the gain or loss realized upon the sale or other disposition of any such obligation. See section 454(b) with respect to the original discount accrued. The provisions of this paragraph may be illustrated by the following examples:

Example 1. A (not a life insurance company) buys a $100,000, 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken into account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example 2. The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

[T.D. 6500, 25 FR 12003, Nov. 26, 1960, as amended by T.D. 7369, 40 FR 29840, July 16, 1975]

§ 1.1221–2 Hedging transactions.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(v) *Transactions that counteract hedging transactions.* If a transaction is entered into primarily to counteract all or any part of the risk reduction effected by one or more hedging transactions, the transaction is a hedging transaction. For example, if a written option is used to reduce or eliminate the risk reduction obtained from another position such as a purchased option, then it may be part of a hedging transaction.

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

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

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

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

(4) *Normal course.* Solely for purposes of paragraph (b) of this section, if a transaction is entered into in furtherance of a taxpayer's trade or business, the transaction is entered into in the normal course of the taxpayer's trade or business. This rule applies even if the risk to be reduced relates to the expansion of an existing business or the acquisition of a new trade or business.

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

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

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

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

(d) *Hedging by members of a consolidated group*—(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 reduce 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

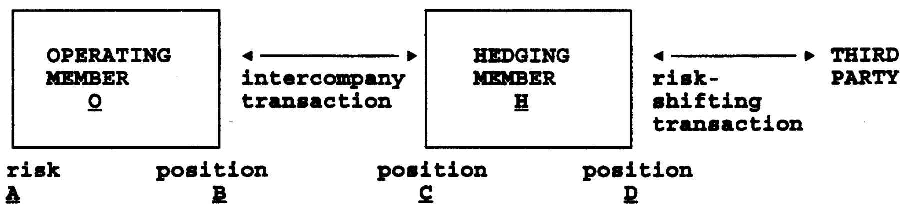
(B) Except as provided in paragraph (f)(3) of this section, the character of the marking member's gain or loss from the transaction is ordinary.

(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.* A taxpayer that enters into a hedging transaction (including recycling an existing hedge) must identify it as a hedging transaction. This identification must be made before the close of the day on which the taxpayer enters into the transaction.

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

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

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

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

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

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

(B) *Debt to be issued.* If the hedging transaction relates to the expected issuance of debt by the taxpayer or to accruals or payments under debt that is expected to be issued by the taxpayer, the identification must specify the following information: the expected date of issuance of the debt; the expected maturity or maturities; the total expected issue price of the issue; and the expected interest provisions. If the hedge is for less than the entire expected issue price of the debt or the full expected term of the debt, the identification must also include the amount or the term being hedged. The identification may indicate a range of dates, terms, and amounts, rather than specific dates, terms, or amounts. For example, a taxpayer might identify a transaction as hedging the yield on an anticipated issuance of fixed rate debt during the second half of its fiscal year, with the anticipated amount of the debt between $75 million and $125 million, and an anticipated term of approximately 20 to 30 years.

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

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

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

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

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

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

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

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

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

(5) *Identification of hedges involving members of a 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)(C).* Any identification for purposes of section 1256(e)(2)(C) is also an identification for purposes of paragraph (e)(1) of this section.

(f) *Effect of identification and non-identification*—(1) *Transactions identified*—(i) *In general.* If a taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (e)(1) of this section, the identification is binding with respect to gain, whether or not all of the requirements of paragraph (e) of this section are satisfied. Thus, gain from that transaction is ordinary income. If the transaction is not in fact a hedging transaction described in paragraph (b) of this section, however, paragraphs (a)(1) and (a)(2) of this section do not apply and the character of loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose. Thus, the taxpayer's identification of the transaction as a hedging transaction does not itself make loss from the transaction ordinary.

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

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

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

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

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

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

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

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

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

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

(3) *Transactions by members of a consolidated group*—(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 dates and transition rules*—(1) *Effective date for identification requirements*—(i) *In general.* Paragraph (e) of this section applies to transactions that—

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(4) *Effective date and transition rules for hedges by members of a consolidated group.* Paragraphs (d), (e)(5), and (f)(3) of this section apply to transactions entered into on or after March 8, 1996.

(5) *Elections to accelerate the effective date of the regulations*—(i) *Election to apply the single-entity approach retroactively.* A consolidated group may elect to begin to apply paragraphs (d) (1) and (3), (e)(5)(i), and (f)(3)(i) of this section to all transactions entered into in any taxable year (the election year) beginning prior to March 8, 1996. This election must be made in the manner, and at the time, prescribed by the Commissioner. A group may make the election only if the election year, and each subsequent taxable year, are still open for assessment under section 6501 on July 1, 1996 (or such earlier date as the Commissioner may allow). The election applies to all transactions entered into in the election year and in all subsequent consolidated return years until the date, if any, as of which the group makes a separate-entity election under paragraph (d)(2) of this section. The rules of paragraph (g)(6) of this section apply to all transactions that were entered into before March 8, 1996 in taxable years subject to an election under this paragraph (g)(5)(i). The election may be revoked only with the consent of the Commissioner.

(ii) *Ability to apply the separate-entity approach retroactively.* Notwithstanding paragraph (g)(4) of this section, the separate-entity election described in paragraph (d)(2) of this section may be made for any taxable year beginning on or after July 12, 1995. If that election is made for a taxable year beginning before March 8, 1996, then paragraphs (d) (2) and (3), (e)(5)(ii), and (f)(3)(ii) of this section apply to all transactions entered into on or after the beginning of that taxable year and while the election is in effect, and the rules of paragraph (g)(6) of this section (other than paragraph (g)(6)(i)) apply to all transactions that were entered into on or after the first day of the first year for which the election is made and before March 8, 1996.

(6) *Transitional identification rules.* To allow a consolidated group to conform to paragraphs (g)(5) (i) and (ii) of this section, this paragraph (g)(6) nullifies certain hedge identifications and permits a member of a consolidated group to add certain hedge identifications. This paragraph (g)(6) applies only to the extent provided in paragraph (g)(5) of this section.

(i) *Intercompany transactions previously identified.* Notwithstanding paragraph (f)(1)(i) of this section, if, for purposes of paragraph (e)(1) of this section, a member identified as a hedging transaction an intercompany transaction (or a transaction that would qualify as an intercompany transaction under §1.1502–13(b)(1) if the taxable year in which the transaction was entered into were described in §1.1502–13(*l*)), the character of the gain on the intercompany transaction is determined as if it had not been identified as a hedging transaction. The identification may, however, serve to identify the hedged item under paragraph (e)(5)(i) of this section.

(ii) *Additional identifications of hedging transactions.* A member of a consolidated group must identify under paragraph (e)(5) of this section a transaction that—

(A) Was entered into before March 8, 1996,

(B) When entered into was not a hedging transaction (as defined in paragraph (b) of this section),

(C) Solely as a result of the group's election under paragraph (g)(5) (i) or (ii) of this section, is a hedging transaction (as defined in paragraph (b) of this section), and

(D) Remains in existence on March 8, 1996.

(iii) *Additional identification of hedged items.* In the case of transactions described in paragraph (g)(6)(ii) of this section, the hedging member must identify under paragraph (e)(5) of this section the item, items, or aggregate risk being hedged.

(iv) *Consistency requirement for hedge identifications.* In identifying transactions as hedging transactions under paragraph (g)(6)(ii) of this section, all of the members of the group must treat similar or identical transactions consistently within the same year and from year to year. If paragraph (g)(6)(ii) of this section requires a member to identify a transaction, and the member fails to identify a transaction as a hedging transaction, but it or another member of the group identifies similar or identical hedging transactions in the same or a subsequent year, then for purposes of paragraphs (f)(2)(iii) and (3) of this section, the member entering into the transaction is treated as having no reasonable grounds for treating the transaction as other than a hedging transaction.

(v) *Extension of time for making additional identifications.* If an identification of a hedging transaction would not be required but for the rules of paragraph (g)(6)(ii) of this section, the identification is timely for purposes of paragraph (e)(1) of this section if made before the close of business on May 7, 1996. If an identification of a hedged item would not be required but for the rules of paragraph (g)(6)(iii) of this section, it is timely for purposes of paragraph (e)(2) of this section if made before the close of business on the later of May 7, 1996 or the last day of the period specified in paragraph (e)(2)(ii) of this section.

[T.D. 8555, 59 FR 36363, July 18, 1994, as amended by T.D. 8653, 61 FR 519, Jan. 8, 1996; 61 FR 11547, Mar. 21, 1996]

§ 1.1222–1 Other terms relating to capital gains and losses.

(a) The phrase *short-term* applies to the category of gains and losses arising from the sale or exchange of capital assets held for 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) or less; the phrase *long-term* to the category of gains and losses arising from the sale or exchange of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). The fact that some part of a loss from the sale or exchange of a capital asset may be finally disallowed because of the operation of section 1211 does not mean that such loss is not *taken into account in computing taxable income* within the meaning of that phrase as used in sections 1222(2) and 1222(4).

(b)(1) In the definition of *net short-term capital gain,* as provided in section 1222(5), the amounts brought forward to the taxable year under section 1212 (other than section 1212(b)(1)(B)) are short-term capital losses for such taxable year.

(2) In the definition of *net long-term capital gain,* as provided in section 1222(7), the amounts brought forward to the taxable year under section 1212(b)(1)(B) are long-term capital losses for such taxable year.

(c) Gains and losses from the sale or exchange of capital assets held for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (described as short-term capital gains and short-term capital losses) shall be segregated from gains and losses arising from the sale or exchange of such assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) (described as long-term capital gains and long-term capital losses).

(d)(1) The term capital gain net income (net capital gain for taxable years beginning before January 1, 1977) means the excess of the gains from sales or exchanges of capital assets over the losses from sales or exchanges of capital assets, which losses include any amounts carried to the taxable year pursuant to section 1212(a) or section 1212(b).

(2) Notwithstanding subparagraph (1) of this paragraph, in the case of a taxpayer other than a corporation for taxable years beginning before January 1, 1964, the term *net capital gain* means the excess of (i) the sum of the gains from sales or exchanges of capital assets, plus the taxable income (computed without regard to gains and losses from sales or exchanges of capital assets and without regard to the deductions provided by section 151, relating to personal exemptions, or any deductions in lieu thereof) of the taxpayer or $1,000, whichever is smaller, over (ii) the losses from sales or exchanges of capital assets, which losses include amounts carried to the taxable year by such taxpayer under paragraph