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

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

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

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

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

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

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DEPARTMENT OF TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–105801–00]

RIN 1545–AX92

Capitalization of Interest and Carrying Charges Properly Allocable to Straddles

AGENCY: Internal Revenue Service (IRS), Treasury.

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

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

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

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

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

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

SUPPLEMENTARY INFORMATION:

Background

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

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

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

Explanation of Provisions

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

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

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

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

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

1092(d)(1) for purposes of section 263(g) could result in dissimilar tax treatment of economically similar transactions. For example, adoption of the narrower definition would cause section 263(g) to apply to a transaction in which a taxpayer borrows to purchase actively traded personal property that is a part of a straddle but not to a similar transaction in which the taxpayer borrows to purchase a derivative instrument that is not itself actively traded but is a position in actively traded property.

Consequently, proposed § 1.263(g)–2 defines personal property as a property right, whether or not actively traded, other than a right in real property. This definition includes both financial positions that provide substantial rights but do not impose substantial obligations on the holder (e.g., common stock or a purchased option) and executory contracts that impose both rights and obligations on the holder (e.g., notional principal contracts (NPC's) and forward transactions). However, the definition excludes straddles comprised only of financial positions that impose only obligations on the holder (e.g., the obligor's position in a debt instrument or a writer's position in an option).

Payments That Are Subject to the Capitalization Rules of Section 263(g)

Section 263(g)(1) provides for the capitalization of interest and carrying charges. For this purpose, *interest and carrying charges* are collectively defined in section 263(g)(2) as ''interest incurred or continued to purchase or carry the personal property'' and ''all other amounts (including charges to insure, store, or transport) paid or incurred to carry the personal property,'' less certain types of income from the personal property.

The phrase ''incurred or continued to purchase or carry'' also appears in section 265(a)(2), which disallows interest expense on indebtedness incurred or continued to purchase or carry tax-exempt debt. Rev. Proc. 72–18 (1972–1 C.B. 740) sets out rules for determining when this standard is met for purposes of section 265(a)(2). Under that revenue procedure, indebtedness issued by a taxpayer that is not a dealer in tax-exempt obligations meets this standard if: (1) The proceeds of the indebtedness are directly traceable to the purchase of the tax-exempt obligations, (2) the tax-exempt obligations are used as collateral for the borrowing, or (3) the totality of the facts and circumstances supports a reasonable inference that the purpose of the borrowing was to purchase or carry tax-exempt obligations. In general, the facts-and-circumstances test is met if there is a ''sufficiently direct relationship'' between the borrowing and the investment in the tax-exempt obligations. Similarly, the proposed regulations provide that a sufficiently direct relationship between indebtedness or other financing and personal property that is part of a straddle exists if payments on the indebtedness or other financing are determined by reference to the value or change in value of the personal property. See § 1.263(g)–3(c).

Section 263(g) also applies to ''all other amounts (including charges to insure, store or transport the personal property)'' paid or incurred to carry personal property that is part of a straddle. As noted by one commentator, ''taxpayers should not be permitted to deduct items incurred in connection with protecting or preserving the value of assets'' that are part of a straddle. Therefore, the term, *to carry* in the context of section 263(g) includes the reduction of the risk of holding an asset. Because straddles necessarily involve positions that offset each other, the positions ''carry'' each other.

Accordingly, under § 1.263(g)–3(b) of the proposed regulations, interest and carrying charges subject to capitalization under section 263(g) include: (1) Otherwise deductible payments or accruals (including interest and original issue discount) on indebtedness or other financing issued or continued to purchase or carry personal property that is part of a straddle; (2) otherwise deductible fees or expenses paid or incurred in connection with the taxpayer's acquiring or holding personal property that is part of a straddle, including, but not limited to, fees or expenses incurred to purchase, insure, store, maintain, or transport the personal property; and (3) other otherwise deductible payments or accruals on financial instruments that are part of a straddle or that carry part of a straddle.

Section 263(g) requires capitalization of interest and carrying charges that exceed certain specified income inclusions (allowable offsets) listed in section 263(g)(2)(B). Section 1.263(g)–3(e) sets forth the allowable offsets, including amounts that are receipts or accruals on financial instruments that are part of a straddle or carry part of a straddle. The Treasury Department and the IRS solicit comments regarding whether other amounts should be treated as allowable offsets for purposes of section 263(g).

Operation of the Capitalization Rules of Section 263(g)

Generally, section 263(g) coordinates the character and timing of items of income and loss attributable to a taxpayer's position in a straddle by allocating interest and carrying charges to the capital account of a position in personal property that is part of the straddle. Proposed regulation § 1.263(g)–4 provides a set of allocation rules governing the ''capitalization'' of interest and carrying charges.

In many cases, certain allocation rules readily suggest themselves.

Congress was aware of ''cash and carry'' transactions in adopting section 263(g). See H.R. Rep. No. 201, 97th Cong. 1st Sess. 203–04 (1981). In a typical transaction, a taxpayer borrows to purchase personal property and sells the property forward. The debt instrument generates ordinary deductions (interest expense) that precede predictable (and approximately equal) capital gains on the sale of the personal property. Coordination of the amount and timing of income and loss in a cash and carry transaction is achieved under the proposed regulation by allocating the interest expense to the capital account of the personal property. This rule applies to all transactions in which a taxpayer has borrowed to purchase personal property that is part of a straddle.

If the proceeds of a borrowing are not used to purchase personal property, a second allocation rule allocates interest expense to personal property when the personal property collateralizes the borrowing. See Rev. Proc. 72–18, § 3.03 (disallowing interest deduction for debt secured by tax-exempt obligations); Rev. Rul. 78–348 (1978–2 C.B. 95) (applying yield restrictions to investments pledged by person benefitting from tax-exempt bond financing).

A third allocation rule of the proposed regulations allocates interest on indebtedness to personal property when payments on the indebtedness are determined by reference to the value, or change in value, of the personal property that is part of a straddle.

Fees and charges related to the maintenance of the personal property, such as charges to insure, store, or transport the personal property, are allocated to the capital account of that personal property. See S. Rep. No. 144, 97th Cong. 1st Sess. 154 (1981).

In other cases, the appropriate method for allocating capitalized interest and carrying charges is less obvious. This may be true of payments or accruals on a financial instrument, such as a NPC, described in proposed § 1.263(g)–3(d).

For example, the proposed rules would apply to a taxpayer that holds stock and enters into an equity swap that is a short position with respect to the stock. In such a case, both the stock and the equity swap may be personal property that is part of a straddle, and payments on the equity swap could be capitalized with respect to the capital account of either the stock or the equity swap. However, it may not be clear how a capitalization rule would apply in conjunction with the rules under § 1.446–3 with respect to payments on NPCs. Accordingly, the proposed rules provide that, in cases to which a specific allocation rule is not applicable, interest and carrying charges will be allocated to personal property that is part of a straddle in the manner that is most appropriate under all the facts and circumstances. Proposed regulations § 1.263(g)–4(c) *Example 7* (relating to a straddle consisting of stock and an equity swap) illustrate one application of this facts and circumstances rule. The Treasury Department and the IRS invite comments and suggestions regarding both the proposed specific allocation rules and the general facts and circumstances allocation rule.

The regulations under section 263(g) are proposed to be effective for expenses paid, incurred, or accrued after the date the regulations are adopted as final for straddles established on or after January 17, 2001. See § 1.263(g)–5.

Obligation Under a Debt Instrument as a Position in Personal Property

If a taxpayer is the obligor under a debt instrument that provides for one or more payments linked to the value of actively traded personal property, the value of the taxpayer's obligation under the debt instrument changes as the value of the referenced property changes. For this reason, the taxpayer's position as obligor under the debt instrument functions as a position in the referenced property.

Some commentators have suggested that a debt instrument (other than one denominated in an actively traded foreign currency) cannot be a position of the obligor in personal property that is part of a straddle. Section 1092(d)(7) provides that an obligor's interest in a nonfunctional-currency-denominated debt instrument is treated under section 1092(d)(2) as a position in the nonfunctional currency. From this, the commentators infer that an obligor's interest in a debt instrument may never be treated as an interest in personal property other than a nonfunctional currency.

However, neither the legislative history nor the express language of section 1092(d)(7) indicates that Congress intended to exclude interests in personal property from the definition of *position* in section 1092(d)(2). A rule that a debt instrument can be a position in currency does not establish that a debt instrument is a position only in currency. This interpretation of section 1092(d)(7) has already been rejected by the IRS and Treasury in § 1.1275–4(b)(9)(vi), which provides that increased interest expense on a contingent payment debt instrument issued by a taxpayer may be a straddle loss subject to section 1092 deferral.

To clarify the definition of *position* under section 1092(d)(2), § 1.1092(d)–1(d) of the proposed regulations explicitly provides that an obligation under a debt instrument may be a position in personal property that is part of a straddle. This provision is proposed to be effective for straddles established on or after January 17, 2001. However, no inference is intended with respect to straddles established prior to Janaury 17, 2001. Thus, in appropriate cases, the IRS may take the position under section 1092(d)(2) that, even in the absence of a regulation, an obligation under a debt instrument was part of a straddle prior to the effective date of § 1.1092(d)–1(d) if the debt instrument functioned economically as an interest in actively traded personal property.

In 1995, the IRS published proposed regulation § 1.1092(d)–(2). See 60 F.R. 21482; FI–21–95, 1995–1 C.B. 935. The proposed regulations clarify the circumstances in which common stock may be personal property for the purposes of section 1092. Because proposed regulation §§ 1.1092(d)–2 and 1.1092(d)–1(d) address similar issues, the IRS proposes to finalize both regulations simultaneously. The Treasury Department and the IRS, therefore, invite additional comment on proposed § 1.1092(d)–(2).

In addition, in 1985, the Treasury Department and the IRS adopted Temporary Regulation § 1.1092(d)–5T(d), which defines the term *loss* for purposes of §§ 1.1092(b)–1T through 1.1092(b)–4T as a loss otherwise allowable under section 165(a). The Treasury Department and the IRS request comments on whether that definition should be expanded to include expenses such as interest and carrying charges or payments on notional principal contracts. If so, how should such a change be coordinated with the proposed regulations in this document?

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

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

A public hearing has been scheduled for May 22, 2001, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC. Due to building security procedures, visitors must enter at the 10th Street entrance located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identifications to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by May 1, 2001. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

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

Section 1.263(g)–1 also issued under 26 U.S.C. 1092(b)(1).

Section 1.263(g)–2 also issued under 26 U.S.C. 1092(b)(1).

Section 1.263(g)–3 also issued under 26 U.S.C. 1092(b)(1).

Section 1.263(g)–4 also issued under 26 U.S.C. 1092(b)(1).

Section 1.263(g)–5 also issued under 26 U.S.C. 1092(b)(1). * * *

Section 1.1092(d)–1 also issued under 26 U.S.C. 1092(b)(1).

Par. 2. Sections 1.263(g)–1, 1.263(g)–2, 1.263(g)–3, 1.263(g)–4, and 1.263(g)–5 are added to read as follows:

§ 1.263(g)–1 Treatment of interest and carrying charges in the case of straddles; in general.

(a) Under section 263(g), no deduction is allowed for interest and carrying charges allocable to personal property that is part of a straddle (as defined in section 1092(c)). The purpose of section 263(g) is to coordinate the character and the timing of items of income and loss attributable to a taxpayer's positions that are part of a straddle. In order to prevent payments or accruals related to a straddle transaction from giving rise to recognition of deductions or losses before related income is recognized and to prevent the items of loss and income from having different character, no deduction is allowed for interest and carrying charges properly allocable to personal property that is part of a straddle. Rather, such amounts are chargeable to the capital account of the personal property to which the interest and carrying charges are properly allocable.

(b) Section 263(g) does not apply if none of the taxpayer's positions that are part of the straddle are personal property. Section 263(g) also does not apply to hedging transactions as defined in section 1256(e) (see section 263(g)(3)) or to securities to which the mark-to-market accounting method provided by section 475 applies (see section 475(d)(1)).

(c) Section 1.263(g)–2 provides a definition of personal property for purposes of section 263(g) and §§ 1.263(g)–1 through 1.263(g)–5. Section 1.263(g)–3 provides a definition of interest and carrying charges for purposes of section 263(g), section 1092, §§ 1.263(g)–1 through 1.263(g)–5, and § 1.1092(b)–4T. Section 1.263(g)–4 provides a set of allocation rules governing the capitalization of amounts to which section 263(g) applies.

§ 1.263(g)–2 Personal property to which interest and carrying charges may properly be allocable.

(a) *Definition of personal property.* For purposes of section 263(g) and of §§ 1.263(g)–1 through 1.263(g)–5, *personal property* means property, whether or not actively traded, that is not real property. For purposes of the preceding sentence, a position in personal property may itself be property. In general, however, a position in personal property is not property of a taxpayer unless the position confers or may confer substantial rights on the taxpayer.

(1) *Application to certain financial instruments.* Personal property includes a stockholder's ownership of common stock, a holder's ownership of a debt instrument, and either party's position in a forward contract or in a conventional swap agreement. Personal property does not include a position that imposes obligations but does not confer substantial rights on the taxpayer. Therefore, the obligor's position in a debt instrument generally is not personal property, even though the obligor may have typical rights of a debtor, such as the right to prepay the debt. However, the obligor on a debt instrument has a position in any personal property underlying the debt instrument. See § 1.1092(d)–1(d).

(2) *Options.* For the purposes of applying this section, a put option or call option imposes obligations but does not confer substantial rights on the grantor, whether or not the option is cash-settled.

(b) Example. The following example illustrates the rules stated in paragraph (a) of this section:

Example. (i) *Facts. A* purchases 100 ounces of gold at a cost of $*x*. *A* transfers the 100 ounces of gold to a trust that issues multiple classes of trust certificates and is treated as a partnership for tax purposes. In return, *A* receives two trust certificates that are not personal property of a type that is actively traded within the meaning of section 1092(d)(1). One certificate entitles *A* to a payment on termination of the trust at the end of four years equal to the value of the 100 ounces of gold up to a maximum value of $($x + y$). The other certificate entitles *A* to a payment equal to the amount by which the value of 100 ounces of gold exceeds $($x + y$) on termination of the trust. *A* sells the second certificate and keeps the first certificate.

(ii) *Analysis.* The trust certificate retained by *A* is property that is not real property. In addition, ownership of the trust certificate confers certain substantial rights on *A*. Therefore, although the trust certificate is not personal property of a type that is actively traded, *A*'s interest in the trust certificate is personal property for purposes of section 263(g).

§ 1.263(g)–3 Interest and carrying charges properly allocable to personal property that is part of a straddle.

(a) *In general.* For purposes of section 263(g), section 1092, §§ 1.263(g)–1 through 1.263(g)–5, and § 1.1092(b)–4T, *interest and carrying charges properly allocable to personal property that is part of a straddle* means the excess of interest and carrying charges (as defined in paragraph (b) of this section) over the allowable income offsets (as defined in paragraph (e) of this section).

(b) *Interest and carrying charges.* Interest and carrying charges are otherwise deductible amounts paid or accrued with respect to indebtedness or other financing incurred or continued to purchase or carry personal property that is part of a straddle and otherwise deductible amounts paid or incurred to carry personal property that is part of a straddle. As provided in section 263(g)(2), interest includes any amount paid or incurred in connection with personal property used in a short sale. Interest and carrying charges include—

(1) Otherwise deductible payments or accruals (including interest and original issue discount) on indebtedness or other financing issued or continued to purchase or carry personal property that is part of a straddle;

(2) Otherwise deductible fees or expenses paid or incurred in connection with acquiring or holding personal property that is part of a straddle including, but not limited to, fees or expenses incurred to purchase, insure, store, maintain or transport the personal property; and

(3) Other otherwise deductible payments or accruals on financial instruments that are part of a straddle or that carry part of a straddle.

(c) *Indebtedness or other financing incurred or continued to purchase or carry personal property that is part of a*

straddle. For purposes of paragraph (b)(1) of this section, indebtedness or other financing that is incurred or continued to purchase or carry personal property that is part of a straddle includes—

(1) Indebtedness or other financing the proceeds of which are used directly or indirectly to purchase or carry personal property that is part of the straddle;

(2) Indebtedness or other financing that is secured directly or indirectly by personal property that is part of the straddle; and

(3) Indebtedness or other financing the payments on which are determined by reference to payments with respect to the personal property or the value of, or change in value of, the personal property.

(d) *Financial instruments that are part of a straddle or that carry part of a straddle.* For purposes of paragraph (b)(3), financial instruments that are part of a straddle or that carry part of a straddle include—

(1) A financial instrument that is part of the straddle;

(2) A financial instrument that is issued in connection with the creation or acquisition of a position in personal property if that position is part of the straddle;

(3) A financial instrument that is sold or marketed as part of an arrangement that involves a taxpayer's position in personal property that is part of the straddle and that is purported to result in either economic realization of all or part of the appreciation in an asset without simultaneous recognition of taxable income or a current tax deduction (for interest, carrying charges, payments on a notional principal contract, or otherwise) reflecting a payment or expense that is economically offset by an increase in value that is not concurrently recognized for tax purposes or has a different tax character (for example, an interest payment that is economically offset by an increase in value that may result in a capital gain in a later tax period); and

(4) Any other financial instrument if the totality of the facts and circumstances support a reasonable inference that the issuance, purchase, or continuation of the financial instrument by the taxpayer was intended to purchase or carry personal property that is part of the straddle.

(e) *Allowable income offsets.* The allowable income offsets are:

(1) The amount of interest (including original issue discount) includible in gross income for the taxable year with respect to such personal property;

(2) Any amount treated as ordinary income under section 1271(a)(3)(A), 1278, or 1281(a) with respect to such personal property for the taxable year;

(3) The excess of any dividends includible in gross income with respect to such property for the taxable year over the amount of any deductions allowable with respect to such dividends under section 243, 244, or 245;

(4) Any amount that is a payment with respect to a security loan (within the meaning of section 512(a)(5)) includible in income with respect to the personal property for the taxable year; and

(5) Any amount that is a receipt or accrual includible in income for the taxable year with respect to a financial instrument described in § 1.263(g)–3(d) to the extent the financial instrument is entered into to purchase or carry the personal property.

§ 1.263(g)–4 Rules for allocating amounts to personal property that is part of a straddle.

(a) *Allocation rules.* (1) Interest and carrying charges paid or accrued on indebtedness or other financing issued or continued to purchase or carry personal property that is part of a straddle are allocated, in the order listed—

(i) To personal property that is part of the straddle purchased, directly or indirectly, with the proceeds of the indebtedness or other financing;

(ii) To personal property that is part of the straddle and directly or indirectly secures the indebtedness or other financing; or

(iii) If all or a portion of such interest and carrying charges are determined by reference to the value or change in value of personal property, to such personal property.

(2) Fees and expenses described in § 1.263(g)–3(b)(2) are allocated to the personal property, the acquisition or holding of which resulted in the fees and expenses being paid or incurred.

(3) In all other cases, interest and carrying charges are allocated to personal property that is part of a straddle in the manner that under all the facts and circumstances is most appropriate.

(b) *Coordination with other provisions.* In the case of a short sale, section 263(g) applies after section 263(h). See sections 263(g)(4)(A) and (h)(6). In case of an obligation to which section 1277 (dealing with deferral of interest deduction allocable to accrued market discount) or 1282 (dealing with deferral of interest deduction allocable to certain accruals on short-term indebtedness) applies, section 263(g) applies after section 1277 and section 1282. See section 263(g)(4)(B). Capitalization under section 263(g) applies before loss deferral under section 1092.

(c) *Examples.* The following examples illustrate the rules stated in §§ 1.263(g)–2, 1.263(g)–3, and 1.263(g)–4.

Example 1. Cash and Carry Silver.

(i) *Facts.* On January 1, 2002, *A* borrows $*x* at 6% interest and uses the proceeds to purchase *y* ounces of silver from *B*. At approximately the same time, *A* enters into a forward contract with *C* to deliver *y* ounces of silver to *C* in one year.

(ii) *Analysis.* The *y* ounces of silver and the forward contract to deliver *y* ounces of silver in one year are offsetting positions with respect to the same personal property and therefore constitute a straddle. See sections 1092(c)(1), (c)(3)(A)(i). The proceeds of the debt instrument were used to purchase personal property that is part of the straddle. Consequently, *A*'s interest payments are interest and carrying charges properly allocable to personal property that is part of a straddle. See § 1.263(g)–3(b)(1) & (c)(1). Under § 1.263(g)–4(a)(1)(i), the interest payments must be charged to the capital account for the *y* ounces of silver purchased by *A* with the proceeds of the borrowing.

Example 2. Additional indebtedness issued to carry personal property.

(i) *Facts.* The facts are the same as for Example 1 except that during the year 2002, the market price of silver increases and *A* is required to post variation margin as security for its obligation to deliver *y* ounces of silver to *C*. *A* incurs additional indebtedness to obtain funds necessary to meet *A*'s variation margin requirement.

(ii) *Analysis.* The additional indebtedness is incurred to continue to carry *A*'s holding of *z* ounces of silver. Consequently, *A*'s interest payments on the additional indebtedness are interest and carrying charges properly allocable to personal property that is part of a straddle and must be charged to the capital account for the *y* ounces of silver.

Example 3. Contingent payment debt instrument.

(i) *Facts.* On January 1, 2002, *D* enters into a contract to deliver *x* barrels of fuel oil to *E* on July 1, 2004, at an aggregate price equal to $*y*. Soon afterward, *D* issues a contingent payment debt instrument to *F* with a principal amount of $*z* and a 2-year term that pays interest quarterly at a rate determined at the beginning of each quarter equal to the greater of zero and the London Interbank Offered Rate (LIBOR) adjusted by an index that varies inversely with changes in the price of fuel oil (so that the interest rate increases as the price of fuel oil decreases and vice versa). The change in the aggregate amount of interest paid on the $*z* of debt due to the functioning of the index approximates the concurrent aggregate change in value of *x* barrels of fuel oil and, thus, the value of *D*'s interest in the forward contract.

(ii) *Analysis.* The debt instrument and the forward contract are offsetting positions with respect to the same personal property and

constitute a straddle. See section 1092(c)(1), (c)(3)(A)(i). When issued, the debt instrument is a position in personal property that is part of a straddle. See § 1.1092(d)–1(d). Consequently, *D*'s interest payments are interest and carrying charges properly allocable to personal property that is part of a straddle and must be allocated to the capital account for the forward contract for the delivery of *x* barrels of fuel oil to *E*. See §§ 1.263(g)–3(b)(1), (b)(3), (c)(3), and (d)(1) and -4(a)(1)(iii).

Example 4. Financial instrument issued to carry personal property that is part of a straddle. (i) *Facts.* The facts are the same as for Example 3 except that *D* also enters into a two-year interest rate swap under which *D* receives LIBOR times a notional principal amount equal to $*z* and pays 7% times $*z*.

(ii) *Analysis.* Because of the relationship between the two-year debt instrument issued by *D* and the interest rate swap, the interest rate swap is a financial instrument that carries personal property that is part of a straddle. See § 1.263(g)–3(d)(4). Net payments made by *D* under the interest rate swap are chargeable to the capital account for the forward contract for the delivery of *x* barrels of fuel oil to *E*. Similarly, net payments received by *D* under the interest rate swap are allowable offsets. See § 1.263(g)–3(e)(5).

Example 5. Contingent payment debt instrument with embedded short position.

(i) *Facts.* On January 1, 1998, G purchases 100,000 shares of the common stock of *XYZ* corporation (which is publicly traded). On January 1, 2002, the 100,000 shares of *XYZ* corporation common stock were worth $*x* per share. On that date, *G* issued a contingent payment debt instrument for $100,000*x*. The terms of the debt instrument provided that the holder would receive an annual payment of $2,000*x* on December 31 of each year up to and including the maturity date of December 31, 2007. On the maturity date, the holders would also receive a payment of $100,000*x* plus an additional amount, if the price of an *XYZ* share exceeded $1.2*x* on such date, equal to 100,000 times three-quarters of the amount of such excess per share. Thus, *G*'s aggregate payments on the debt instrument varied directly with the increase in value in the *XYZ* shares.

(ii) *Analysis.* The debt instrument is a position in *XYZ* stock. See § 1.1092(d)–1(d). The *XYZ* stock is personal property within the meaning of section 1092(d)(3)(B) because the debt instrument is a position with respect to substantially similar or related property (other than stock) within the meaning of section 1092(d)(3)(B)(i)(II). See § 1.1092(d)–2(c). The debt instrument and the *XYZ* shares are offsetting positions with respect to the same personal property and constitute a straddle. See sections 1092(c)(1), (c)(3)(A)(i). Consequently, *G*'s interest payments are interest and carrying charges properly allocable to personal property that is part of a straddle, see §§ 1.263(g)–3(b)(1), (b)(3), (c)(3), and (d)(1), and must be allocated to the capital account for the *XYZ* common stock, see § 1.263(g)–4(a)(1)(iii) and (a)(3).

Example 6. Straddle including partnership interest.

(i) *Facts.* H borrows money from I to purchase 100 ounces of gold at a cost of $*u*. *H* transfers the 100 ounces of gold and $*v* to a newly created trust that issues multiple classes of trust certificates and is treated as a partnership for tax purposes. In return, *H* receives two trust certificates. One certificate entitles the holder to a payment on termination of the trust at the end of four years equal to the value of the 100 ounces of gold up to a maximum value of $($u + w$). The other certificate entitles the holder to a payment equal to the amount by which the value of 100 ounces of gold exceeds $($u + w$) on termination of the trust. *H* sells the second certificate and keeps the first certificate. *H* also enters into a forward contract to sell 100 ounces of gold for $1.12*u* per ounce on a date two years after creation of the trust. The trust uses part of the $*v* and similar cash contributions from other investors to pay costs of storing the gold held by the trust and allocates *H*'s share of the expenses to *H*.

(ii) *Analysis.* The trust certificate retained by *H* and the forward contract entered into by *H* are personal property for the purposes of section 263(g). See § 1.263(g)–2(a). They are also offsetting positions and constitute a straddle. Section 1092(c)(1). The borrowing from *I* is an indebtedness incurred to purchase personal property that is part of a straddle. See §§ 1.263(g)–3(b)(1) and (c)(1). Similarly, the gold storage expenses are expenses incurred due to the taxpayer's holding personal property that is part of a straddle. See § 1.263(g)–3(b)(2). Therefore both the interest on the borrowing and the gold storage expenses must be allocated to the capital account for the partnership interest represented by the retained trust certificate. See § 1.263(g)–4(a)(1)(i) and (a)(2).

Example 7. Equity Swap.

(i) *Facts.* On January 1, 1998, *J* purchases 100,000 shares of the common stock of *XYZ* corporation (which is publicly traded). On December 31, 2001, the 100,000 shares of *XYZ* corporation common stock were worth $*x* per share. On that date, *J* entered into a NPC with *K*. The terms of the NPC provided that *K* would receive an annual payment on December 31 of each year equal to 100,000 times any appreciation in the value of a share of *XYZ* corporation stock above its price at the end of trading on December 31 of the preceding year and 100,000 times the dividends paid during the year on each share of *XYZ* corporation stock. In return, on December 31 of each year, *J* would receive an amount equal to LIBOR times the value of 100,000 XYZ shares at the end of trading on December 31 of the preceding year plus 100,000 times the amount of any decrease in the value of a share of *XYZ* corporation stock below its price at the end of trading on December 31 of the preceding year. Payments between *J* and *K* would be netted and continue up to and including the maturity date of the NPC on December 31, 2008. Thus, *J*'s aggregate payments on the NPC varied directly with the increase in value in the *XYZ* shares.

(ii) *Analysis.* The NPC is a position in *XYZ* stock. See § 1.1092(d)–2(c). The *XYZ* stock is personal property within the meaning of section 1092(d)(3)(B) because the NPC is a position with respect to substantially similar or related property (other than stock) within the meaning of section 1092(b)(3)(B)(i)(II). See § 1.1092(d)–2(a)(1)(ii). The NPC and the *XYZ* shares are offsetting positions with respect to the same personal property and constitute a straddle. See sections 1092(c)(1), (c)(3)(A)(i). Consequently, *J*'s payments are interest and carrying charges properly allocable to personal property that is part of a straddle. See §§ 1.263(g)–3(b)(3) and (d)(1). Therefore, they should be allocated to the personal property that is part of the straddle in the manner that is most appropriate under all the facts and circumstances. In this case, because these payments are incurred to carry the *XYZ* shares, they should be allocated to the capital account for the *XYZ* common stock. See § 1.263(g)–4(a)(3).

§ 1.263(g)–5 Effective dates.

Sections 1.263(g)–1, 1.263(g)–2, 1.263(g)–3, and 1.263(g)–4 apply to interest and carrying charges properly allocable to personal property that are paid, incurred, or accrued after the date these regulations are adopted as final regulations by publication in the **Federal Register** for a straddle established on or after January 17, 2001.

Par. 3. Section 1.1092(d)–1 is amended by revising paragraph (d) and adding paragraph (e), to read as follows:

§ 1.1092(d)–1 Definitions and special rules.

* * * * *

(d) *Debt instrument linked to the value of personal property.* If a taxpayer is the obligor under a debt instrument one or more payments on which are linked to the value of personal property or a position with respect to personal property, then the taxpayer's obligation under the debt instrument is a position with respect to personal property and may be part of a straddle.

(e) *Effective dates.* Paragraph (b)(1)(vii) of this section applies to positions entered into on or after October 14, 1993. Paragraph (c) of this section applies to positions entered into on or after July 8, 1991. Paragraph (d) of this section is effective for straddles established on or after January 17, 2001.

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

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