

daily basis for the entire term of the contract, the contract is described in paragraph (g)(4)(ii)(B)(1) of this section and paragraph (g)(4)(i) of this section does not apply to the contract.

Example 4. Full margin—uncleared contract. (i) On June 1, 2016, P, a domestic corporation, enters into an interest rate swap contract with an unrelated domestic counterparty, CP. Under the terms of the contract, CP agrees to make five annual payments to P equal to a specified contract rate of 3% times the notional amount of \$10,000,000 plus an up-front payment of \$1,878,030. In exchange, P agrees to make five annual payments to CP equal to the same notional amount times LIBOR. At the time the parties enter into the contract, the fixed rate for an on-market swap is 7.52%. The contract is not required to be cleared and is not accepted for clearing by a U.S.-registered derivatives clearing organization. However, pursuant to the terms of the contract, P is obligated to post \$1,878,030 as collateral with CP, and P and CP are obligated to post and collect collateral each business day in an amount equal to the daily change in the fair market value of the contract for the entire term of the contract. All collateral on the contract is required to be in U.S. dollars.

(ii) Because the contract is required to be collateralized in an amount equal to the up-front payment and changes in the fair market value of the contract on a daily basis for the entire term of the contract, the contract is described in paragraph (g)(4)(ii)(B)(2) of this section and paragraph (g)(4)(i) of this section does not apply to the contract.

(h) through (j)(1) [Reserved]. For further guidance, see §1.446-3(h) through (j)(1).

(2) *Application of §1.446-3T(g)(4).* Paragraph (g)(4)(i) of this section and paragraph (g)(6) *Example 2* of this section apply to notional principal contracts entered into on or after the later of January 1, 2017, or 180 days after the date of publication of the Treasury decision adopting these rules as final regulations in the FEDERAL REGISTER. Paragraph (g)(4)(ii) of this section applies to notional principal contracts entered into on or after May 8, 2015. However, before the later of January 1, 2017, or 180 days after the date of publication of the Treasury decision adopting paragraph (g)(4)(i) of this section as final regulations in the FEDERAL REGISTER, taxpayers may rely on the provision in §1.446-3(g)(4), as contained in 26 CFR part 1, revised April 1, 2015, which (except for purposes of section 956) limits the application of the embedded

loan rule to nonperiodic payments that are significant, even if the requirements for the exceptions in paragraph (g)(4)(ii) of this section are not met. Taxpayers may apply paragraph (g)(4)(i) of this section, paragraph (g)(4)(ii) of this section, or both to notional principal contracts entered into before the dates set forth in this paragraph (j)(2).

(k) *Expiration date.* The applicability of paragraph (g)(4) of this section and paragraph (g)(6) *Examples 2, 3 and 4* of this section expires May 7, 2018.

[T.D. 9719, 80 FR 26440, May 8, 2015, as amended by 80 FR 61308, Oct. 13, 2015]

§ 1.446-4 Hedging transactions.

(a) *In general.* Except as provided in this paragraph (a), a hedging transaction as defined in §1.1221-2(b) (whether or not the character of gain or loss from the transaction is determined under §1.1221-2) must be accounted for under the rules of this section. To the extent that provisions of any other regulations governing the timing of income, deductions, gain, or loss are inconsistent with the rules of this section, the rules of this section control.

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

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

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

(ii) An integrated transaction subject to §1.1275-6;

(iii) Any section 988 hedging transaction if the transaction is integrated under §1.988-5 or if other regulations issued under section 988(d) (or an advance ruling described in 1.988-5(e))

govern when gain or loss from the transaction is taken into account; or

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

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

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

(d) *Recordkeeping requirements—(1) In general.* The books and records maintained by a taxpayer must contain a description of the accounting method used for each type of hedging trans-

action. The description of the method or methods used must be sufficient to show how the clear reflection requirement of paragraph (b) of this section is satisfied.

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

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

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

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

risk, taking into account income, deduction, gain, or loss under the provisions of § 1.446-3 may clearly reflect income. See paragraph (e)(5) of this section.

(ii) *Mark-and-spread method.* The following method may be appropriate for taking into account income, deduction, gain, or loss from hedges of aggregate risk:

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

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

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

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

loss from the hedge with the timing of aggregate income, deduction, gain, or loss from the hedged purchases or sales, it may be appropriate for a taxpayer to account for its hedging transactions in the manner described in paragraph (e)(1)(ii) of this section, except that the gain or loss that is spread to each period is taken into account when it would be if it were an element of cost incurred (purchase hedges), or an element of proceeds from sales made (sales hedges), during that period.

(ii) *Alternative methods for certain inventory hedges.* In lieu of the method described in paragraph (e)(3)(i) of this section, other simpler, less precise methods may be used in appropriate cases where the clear reflection requirement of paragraph (b) of this section is satisfied. For example:

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

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

(4) *Hedges of debt instruments.* Gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by a taxpayer, must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. A hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, for example, generally is accounted for using constant yield principles. Thus, assuming that a fixed rate or qualified floating rate instrument remains outstanding, hedging gain or loss is taken

into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. For example, gain or loss realized on a transaction that hedged an anticipated fixed rate borrowing for its entire term is accounted for, solely for purposes of this section, as if it decreased or increased the issue price of the debt instrument. Similarly, gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to §1.1275-4(c) (a contingent payment debt instrument issued for nonpublicly traded property) is taken into account when the contingent payment is taken into account under §1.1275-4(c).

(5) *Notional principal contracts.* The rules of §1.446-3 govern the timing of income and deductions with respect to a notional principal contract unless, because the notional principal contract is part of a hedging transaction, the application of those rules would not result in the matching that is needed to satisfy the clear reflection requirement of paragraph (b) and, as applicable, (e)(4) of this section. For example, if a notional principal contract hedges a debt instrument, the method of accounting for periodic payments described in §1.446-3(e) and the methods of accounting for nonperiodic payments described in §1.446-3(f)(2)(iii) and (v) generally clearly reflect the taxpayer's income. The methods described in §1.446-3(f)(2)(ii) and (iv), however, generally do not clearly reflect the taxpayer's income in that situation.

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

to dispose of the hedging transaction within a reasonable period and the hedging transaction is not actually disposed of within that period, the taxpayer must match the gain or loss on the hedge at the end of the reasonable period with the gain or loss on the disposed item. For purposes of this paragraph (e)(6), a reasonable period is generally 7 days.

(7) *Recycled hedges.* If a taxpayer enters into a hedging transaction by recycling a hedge of a particular hedged item to serve as a hedge of a different item, as described in §1.1221-2(d)(4), the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged item, items, or aggregate risk. Income, deduction, gain, or loss attributable to the period after the recycling must be matched to the new hedged item, items, or aggregate risk under the principles of paragraph (b) of this section.

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

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

(9) *Hedging by members of a consolidated group—(i) General rule: single-entity approach.* In general, a member of a consolidated group must account for its hedging transactions as if all of the members were separate divisions of a single corporation. Thus, the timing of the income, deduction, gain, or loss on a hedging transaction must match the timing of income, deduction, gain, or loss from the item or items being hedged. Because all of the members are treated as if they were divisions of a single corporation, intercompany

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transactions are neither hedging transactions nor hedged items for these purposes.

(ii) *Separate-entity election.* If a consolidated group makes an election under § 1.1221-2(e)(2), then paragraph (e)(9)(i) of this section does not apply. Thus, in that case, each member of the consolidated group must account for its hedging transactions in a manner that meets the requirements of paragraph (b) of this section. For example, the income, deduction, gain, or loss from intercompany hedging transactions (as defined in § 1.1221-2(e)(2)(ii)) is taken into account under the timing rules of § 1.446-4 rather than under the timing rules of § 1.1502-13.

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

(iv) *Effective date.* This paragraph (e)(9) applies to transactions entered into on or after March 8, 1996.

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

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

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

that is included in its Federal income tax return for that taxable year.

[T.D. 8554, 59 FR 36358, July 18, 1994, as amended by T.D. 8653, 61 FR 519, Jan. 8, 1996; T.D. 8674, 61 FR 30138, June 14, 1996; T.D. 8985, 67 FR 12865, Mar. 20, 2002; 67 FR 31955, May 13, 2002]

§ 1.446-5 Debt issuance costs.

(a) *In general.* This section provides rules for allocating debt issuance costs over the term of the debt. For purposes of this section, the term *debt issuance costs* means those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under § 1.263(a)-5. If these costs are otherwise deductible, they are deductible by the issuer over the term of the debt as determined under paragraph (b) of this section.

(b) *Method of allocating debt issuance costs—(1) In general.* Solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt. See § 1.1273-2 to determine issue price. Thus, debt issuance costs increase or create original issue discount and decrease or eliminate bond issuance premium.

(2) *Original issue discount.* Any resulting original issue discount is taken into account by the issuer under the rules in § 1.163-7, which generally require the use of a constant yield method (as described in § 1.1272-1) to compute how much original issue discount is deductible for a period. However, see § 1.163-7(b) for special rules that apply if the total original issue discount on the debt is *de minimis*.

(3) *Bond issuance premium.* Any remaining bond issuance premium is taken into account by the issuer under the rules of § 1.163-13, which generally require the use of a constant yield method for purposes of allocating bond issuance premium to accrual periods.

(c) *Examples.* The following examples illustrate the rules of this section:

Example 1. (i) On January 1, 2004, X borrows \$10,000,000. The principal amount of the loan (\$10,000,000) is repayable on December 31, 2008, and payments of interest in the amount of \$500,000 are due on December 31 of each