

## Section 446.—General Rule for Methods of Accounting

26 CFR 1.446-4: Hedging transactions.  
(Also §§ 1221; 1.1221-2.)

**Hedge identification.** This ruling holds that for purposes of the income timing rules in regulations section 1.446-4,

the hedging transaction definition in section 1.1221-2(b) is not modified by section 1.1221-2(g)(2), which deals with the effects on income characterization of a mis-identification or failure to identify a hedging transaction. If a taxpayer has used a method of accounting for a type of hedging transaction but, under section 1.446-4, that method is impermissible for those transactions, the taxpayer must obtain the Commissioner's consent before changing to a method of accounting that is permitted.

### Rev. Rul. 2003-127

#### ISSUES

(1) If a transaction satisfies the definitions of a hedging transaction in § 1221(b)(2)(A) of the Internal Revenue Code and § 1.1221-2(b) of the Income Tax Regulations but the taxpayer fails to identify the transaction under §§ 1.1221-2(f) and 1.446-4(d)(2), must the taxpayer nevertheless account for the transaction using a method of accounting that is permissible under § 1.446-4?

(2) If a taxpayer has used a method of accounting for a type of hedging transaction but, under § 1.446-4, that method is impermissible for that type of transaction, is the taxpayer required to obtain the Commissioner's consent before changing to a method of accounting permitted by § 1.446-4?

#### FACTS

In the normal course of *H*'s trade or business, *H* borrows money and enters into a contract to manage the risk of interest rate changes with respect to that borrowing. The contract is not a § 1256 contract as defined in § 1256(b) of the Code. *H* fails to identify the contract as a hedging transaction under § 1.1221-2(f). *H*'s failure to identify the contract as a hedging transaction does not satisfy the conditions for the application of either § 1.1221-2(g)(2)(ii) (which addresses certain inadvertent errors) or § 1.1221-2(g)(iii) (which provides an anti-abuse rule). In addition, *H* fails to comply with the identification requirements in § 1.446-4(d)(2). Section 1.446-4(a)(1) and (2), which sets forth exceptions to the general rules in § 1.446-4, does not apply to the contract.

*H* has previously established a method of accounting for hedging transactions of this type, but the method is not a permissible method under § 1.446-4.

#### LAW AND ANALYSIS

##### *Issue (1)*

Section 1221 defines a capital asset as property that is not described in § 1221(a)(1) through § 1221(a)(8). Among the excluded classes of property are the transactions described in § 1221(a)(7) that are clearly identified as hedging transactions before the close of the day on which they are acquired, originated, or entered into. Thus, to be excluded from treatment as a capital asset under § 1221(a)(7), a transaction must fall within the definition of a hedging transaction and must be properly identified as a hedging transaction.

The term "hedging transaction" is defined in § 1221(b)(2)(A) and § 1.1221-2(b) as any transaction entered into by a taxpayer in the normal course of the taxpayer's trade or business primarily to manage the risks specified in § 1221(b)(2)(A)(i) through (iii). Because the contract is entered into in the normal course of *H*'s business primarily to manage the risk of interest rate changes with respect to a borrowing, the contract falls within the definition of a hedge set forth in § 1221(b)(2)(A)(i) and § 1.1221-2(b)(2).

The general requirements for a proper identification, as required by § 1221(a)(7), are set forth in § 1.1221-2(f). Additional identification requirements are set forth in § 1.446-4(d)(2). Furthermore, § 1221(b)(2)(B) specifically directs the Secretary to prescribe regulations that properly characterize any income, gain, expense, or loss arising from a transaction that (1) is a hedging transaction but is not properly identified under § 1221(a)(7) or (2) is not a hedging transaction but is so identified. Section 1.1221-2(g)(2) generally provides that a failure to make a proper identification under § 1.1221-2(f)(1) "establishes that a transaction is not a hedging transaction" and that the rules of § 1.1221-2(a)(1) and (2) (providing special rules for the character of gain or loss) do not apply. Consequently, because *H* fails to identify the contract as a hedging transaction under § 1.1221-2(f),

and because the exceptions set forth in §§ 1.1221-2(g)(2)(ii) or (iii) do not apply, then § 1.1221-2(a)(1) and (2) do not apply to the contract.

Section 1.446-4(a) provides that “a hedging transaction as defined in § 1.1221-2(b) (whether or not the character of the gain or loss from the transaction is determined under § 1.1221-2) must be accounted for under the rules of [§ 1.446-4].” Because § 1.1221-2(g) causes *H*'s contract to fail to be a hedging transaction for purposes of § 1.1221-2(a)(1) and (2), the question arises whether *H*'s contract also fails to be a hedging transaction for purposes of § 1.446-4(a).

*H*'s contract is a hedging transaction for purposes of § 1.446-4. First, the definitions of a hedging transaction set forth in § 1221(b)(2)(A) and § 1.1221-2(b) do not contain an identification requirement. In fact, § 1221(b)(2)(B) refers to a transaction “which is a hedging transaction but which was not identified as such in accordance with [§ 1221(a)(7)] ... .” This language indicates that, even though § 1221(a)(7) does not cause the transaction to give rise to ordinary income or loss unless it is properly identified, that transaction may nevertheless be a hedging transaction.

Second, § 1.446-4(a) refers only to the definition of a hedging transaction in § 1.1221-2(b) and does not refer to the additional rules contained in § 1.1221-2(g)(2) regarding the treatment of unidentified transactions.

Third, the purpose of §§ 1221(a)(7) and 1221(b) is to address the character of income or loss. Specifically, these sections match the character of the hedge to that of the hedged item in a manner that is generally advantageous to taxpayers. The purpose of § 1.446-4 is to clearly reflect income by matching the timing of income, gain, loss, and deductions of a hedging transaction to income, gain, loss and deductions of a hedged item. This purpose is independent of character of income and loss. Thus, § 1.1221-2(g)(1) and (2) affects the character of income or loss but does not modify the definition of a hedging transaction under § 1221(b)(2)(A) and § 1.1221-2(b). Despite *H*'s failure to identify the contract as a hedging transaction under § 1.1221-2(f)(1), *H*'s failure to identify the hedged item, items, or aggregate

risk under § 1.1221-2(f)(2), and *H*'s failure to comply with the identification requirements in § 1.446-4(d)(2), *H* must account for income, deduction, gain, or loss on the contract using a method of accounting that clearly reflects income under § 1.446-4.

#### *Issue (2)*

Section 1.446-4 provides guidance regarding methods of accounting that clearly reflect income from hedging transactions. See § 1.446-4(b), which states that “[t]o 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 the income, deduction, gain, or loss from the item or items being hedged.” Each method of accounting used by a taxpayer must clearly reflect income.

Section 1.446-4(c) generally permits a taxpayer to adopt a method of accounting that clearly reflects the taxpayer's income from a particular type of transaction. 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 may only be changed with the consent of the Commissioner, as provided by § 446(e) and the applicable regulations and procedures.

Rev. Rul. 90-38, 1990-1 C.B. 57, holds that in determining gross income or deductions, the treatment of a material item in the same way for two or more consecutively filed tax returns represents consistent treatment of that item for purposes of § 1.446-1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, the taxpayer need not have treated the item consistently in two or more consecutive tax returns to have adopted a method of accounting. If a taxpayer has adopted a method of accounting, the taxpayer may not change the method by amending its prior income tax returns.

Despite *H*'s failure to identify the contract as a hedging transaction under § 1.1221-2(f) and *H*'s failure to comply with the identification requirements in § 1.446-4(d)(2), *H* must account for the gain or loss on the contract using a method of accounting that clearly reflects income

under § 1.446-4. See § 1.446-1(b)(1) (which provides that if the taxpayer does not regularly employ a method of accounting which clearly reflects income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income). Because *H* has previously adopted a method of accounting for the same type of hedging transaction, *H* must use that method to account for the gain or loss on the contract unless *H* obtains the consent of the Commissioner to change to a method that satisfies § 1.446-4. See § 1.446-1(e)(2)(i) (which provides that a taxpayer must obtain the consent of the Commissioner before changing its method of accounting, whether or not its method of accounting is permissible) and § 446(f) (which provides that failure to file a request to change the method of accounting does not prevent the imposition, or diminish the amount of, any penalties or additions to tax). See Rev. Proc. 97-27, 1997-1 C.B. 680, for the procedure to obtain the Commissioner's consent to change to a permissible method.

#### HOLDINGS

(1) If a transaction satisfies the definitions of a hedging transaction in § 1221(b)(2)(A) and § 1.1221-2(b), the taxpayer must account for the transaction using a method of accounting that is permissible under § 1.446-4, even if the taxpayer fails to identify the transaction under §§ 1.1221-2(f) and 1.446-4(d)(2).

(2) If a taxpayer has used a method of accounting for a type of hedging transaction but, under § 1.446-4, that method is impermissible for those transactions, the taxpayer must obtain the Commissioner's consent before changing to a method of accounting permitted by § 1.446-4.

#### DRAFTING INFORMATION

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