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**Section 1258.—Recharacterization of Gain from Certain Financial Transactions**

26 CFR 1.1258–1: Netting rule for certain conversion transactions.

T.D. 8649

**DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Parts 1 and 602**

**Regulations Under Section 1258 of the Internal Revenue Code of 1986; Netting Rule For Certain Conversion Transactions**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to conversion transactions. These regulations provide that certain gains and losses from positions of the same conversion transaction may be netted for purposes of determining the amount of gain that is recharacterized as ordinary income. These regulations reflect changes to the law made by the Revenue Reconciliation Act of 1993 and affect persons who enter into conversion transactions.

DATE: These regulations are effective December 21, 1995.

For applicability of these regulations, see EFFECTIVE DATES under the SUPPLEMENTARY INFORMATION part of the preamble.

FOR FURTHER INFORMATION CONTACT: Alan B. Munro, (202) 622-3950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

*Paperwork Reduction Act*

The collection of information contained in these final regulations has

been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1452. Responses to this collection of information are required to obtain netting relief for conversion transactions.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per recordkeeper varies from .05 to 10 hours, depending on individual circumstances, with an estimated average of .10 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

*Background*

On December 27, 1994, the IRS published in the Federal Register a notice of proposed rulemaking and notice of public hearing at 59 FR 66498 (FI–43–94 [1995–1 C.B. 932]) under section 1258 of the Internal Revenue Code of 1986.

The IRS received a number of written comments on the proposed regulations. No requests to speak at the public hearing were received, however, and consequently the hearing was cancelled.

*Explanation of Provisions*

*A. General*

The proposed regulations allow taxpayers to net gains and losses on the positions of certain conversion transactions for purposes of section 1258(a). For a taxpayer to be eligible, the

proposed regulations require the taxpayer to identify, before the close of the day on which the positions become part of the conversion transaction, all the positions that are part of the conversion transaction. In addition, the taxpayer has to dispose of all the positions within a 14-day period that is within a single taxable year. The proposed regulations also define built-in loss and prohibit the netting of built-in loss against gain.

The commenters uniformly supported the netting relief provided by the proposed regulations. Accordingly, the final regulations are substantially unchanged from the proposed regulations.

The proposed regulations provide that the regulations will be effective for conversion transactions entered into on or after the date of filing of final regulations with the Federal Register. Several commenters requested that the regulations also apply to conversion transactions entered into prior to the filing date. In response to these comments, the final regulations provide for application of the regulations to any conversion transaction that is outstanding on December 21, 1995, provided that all the positions which are part of the conversion transaction are identified under §1.1258–1(b)(2) before the close of business on February 20, 1996. The final regulations also provide a transition rule for the same-day identification requirement that allows taxpayers to identify conversion transactions entered into prior to February 20, 1996, at any time on or before February 20, 1996.

Several commenters criticized the examples for failing to adjust the applicable imputed income amount (AIIA) under section 1258(b) for interest and dividends received. The scope of these regulations, however, is limited to netting relief. The IRS is still studying various situations to determine the extent to which it is appropriate to reduce the AIIA by reason of amounts capitalized under section 263(g), ordinary income received, or otherwise. Accordingly, Example 3 has been deleted and Examples 1 and 2 have been clarified to eliminate any implication on this issue.

One commenter requested that the identification requirement be eliminated as impractical, unnecessary, and a trap for the unwary. This same-day identification requirement is similar to identification requirements under sections 475 and 1221. Identification of all the

positions of a conversion transaction will aid examiners attempting to determine whether conversion transactions are present and will prevent mismatching of those positions by both taxpayers and agents. The final regulations retain the same-day identification requirement but provide a transition rule.

Some commenters asked that netting relief be expanded to cover unrealized losses in retained positions by allowing loss positions to be marked to market when a gain position is disposed of or terminated. Allowing retained positions to be marked to market raises valuation and other potentially complex issues. For example, many of the issues addressed by the regulations under section 475 would have to be addressed here. The complexity of these issues outweighs the potential benefit of allowing retained positions to be marked to market. Thus, the final regulations do not include a mark-to-market provision.

To preserve the character of gain that arose before a position became part of a conversion transaction, one commenter requested built-in gain rules similar to the built-in loss rules in the proposed regulations. The appropriateness of a built-in gain rule under section 1258 is beyond the scope of these regulations. Therefore, the final regulations do not address this issue.

The IRS is aware that section 1258 presents a number of issues not addressed by these final regulations. The IRS continues to study the scope of section 1258, the types of transactions that should be included under the regulatory authority of section 1258(c)(2)(D), and what reductions, if any, in the AIA are appropriate under section 1258(b). The IRS welcomes comments on these and other issues under section 1258.

#### *B. Effective Dates*

The regulations are effective for conversion transactions that are outstanding on or after December 21, 1995. In the case of a conversion transaction entered into before February 20, 1996, the same-day identification requirement is treated as satisfied if the identification is made on or before February 20, 1996.

#### *Special Analyses*

It has been determined that this Treasury decision is not a significant

regulatory action as defined in EO 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) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

#### *Drafting Information*

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

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#### *Adoption of Amendments to the Regulations*

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

#### **PART 1—INCOME TAXES**

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.1258-1 is added to read as follows:

#### *§1.1258-1 Netting rule for certain conversion transactions.*

(a) *Purpose.* The purpose of this section is to provide taxpayers with a method to net certain gains and losses from positions of the same conversion transaction before determining the amount of gain treated as ordinary income under section 1258(a).

(b) *Netting of gain and loss for identified transactions—(1) In general.* If a taxpayer disposes of or terminates all the positions of an identified netting transaction (as defined in paragraph (b)(2) of this section) within a 14-day period in a single taxable year, all gains and losses on those positions taken into account for federal tax purposes within that period (other than

built-in losses as defined in paragraph (c) of this section) are netted solely for purposes of determining the amount of gain treated as ordinary income under section 1258(a). For purposes of the preceding sentence, a taxpayer is treated as disposing of any position that is treated as sold under any provision of the Code or regulations thereunder (for example, under section 1256(a)-(1)).

(2) *Identified netting transaction.* For purposes of this section, an identified netting transaction is a conversion transaction (as defined in section 1258(c)) that the taxpayer identifies as an identified netting transaction on its books and records. Identification of each position of the conversion transaction must be made before the close of the day on which the position becomes part of the conversion transaction. No particular form of identification is necessary, but all the positions of a single conversion transaction must be identified as part of the same transaction and must be distinguished from all other positions.

(c) *Definition of built-in loss.* For purposes of this section, built-in loss means—

(1) Built-in loss as defined in section 1258(d)(3)(B); and

(2) If a taxpayer realizes gain or loss on any one position of a conversion transaction (for example, under section 1256), as of the date that gain or loss is realized, any unrecognized loss in any other position of the conversion transaction that is not disposed of, terminated, or treated as sold under any provision of the Code or regulations thereunder within 14 days of and within the same taxable year as the realization event.

(d) *Examples.* These examples illustrate this section:

*Example 1. Identified netting transaction with simultaneous actual dispositions.* (i) On December 1, 1995, A purchases 1,000 shares of XYZ stock for \$100,000 and enters into a forward contract to sell 1,000 shares of XYZ stock on November 30, 1997, for \$110,000. The XYZ stock is actively traded as defined in §1.1092(d)-1(a) and is a capital asset in A's hands. A maintains books and records on which, on December 1, 1995, it identifies the two positions as all the positions of a single conversion transaction. A owns no other XYZ stock. On December 1, 1996, when the applicable imputed income amount for the transaction is \$7,000, A sells the 1,000 shares of XYZ stock for \$95,000. On the same day, A terminates its forward contract with its counterparty, receiving \$10,200. No dividends were received on the stock during

the time it was part of the conversion transaction.

(ii) The XYZ stock and forward contract are positions of a conversion transaction. Under section 1258(c)(1), substantially all of A's expected return from the overall transaction is attributable to the time value of the net investment in the transaction. Under section 1258(c)(2)(B), the transaction is an applicable straddle as defined in section 1258(d)(1).

(iii) A disposed of or terminated all the positions of the conversion transaction within 14 days and within the same taxable year as required by paragraph (b)(1) of this section. The transaction is an identified netting transaction because it meets the identification requirement of paragraph (b)(2) of this section. Solely for purposes of section 1258(a), the \$5,000 loss realized (\$100,000 basis less \$95,000 amount realized) on the disposition of the XYZ stock is netted against the \$10,200 gain recognized on the disposition of the forward contract. Thus, the net gain from the conversion transaction for purposes of section 1258(a) is \$5,200 (\$10,200 gain less \$5,000 loss). Only the \$5,200 net gain is re-characterized as ordinary income under section 1258(a) even though the applicable imputed income amount is \$7,000. For federal tax purposes other than section 1258(a), A has recognized a \$10,200 gain on the disposition of the forward contract (\$5,200 of which is treated as ordinary income) and realized a separate \$5,000 loss on the sale of the XYZ stock.

*Example 2. Identified netting transaction with built-in loss.* (i) The facts are the same as in *Example 1*, except that A had purchased the XYZ stock for \$104,000 on May 15, 1995. The XYZ stock had a fair market value of \$100,000 on December 1, 1995, the date it became part of a conversion transaction.

(ii) The results are the same as in *Example 1*, except that A has built-in loss (in addition to the \$5,000 loss that arose economically during the period of the conversion transaction), as defined in section 1258(d)(3)(B), of \$4,000 on the XYZ stock. That \$4,000 built-in loss is not netted against the \$10,200 gain on the forward contract for purposes of section 1258(a). Thus, the net gain from the conversion transaction for purposes of section 1258(a) is \$5,200, the same as in *Example 1*. The \$4,000 built-in loss is recognized and has a character determined without regard to section 1258.

(e) *Effective date and transition rule*—(1) *In general.* These regulations are effective for conversion transactions that are outstanding on or after December 21, 1995.

(2) *Transition rule for identification requirements.* In the case of a conversion transaction entered into before February 20, 1996, paragraph (b)(2) of this section is treated as satisfied if the identification is made before the close of business on February 20, 1996.

PART 602—OMB CONTROL  
NUMBERS UNDER THE  
PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

**§602.101 [Amended]**

Par. 4. In §602.101, paragraph (c) is amended by adding the entry “1.1258–1 .... 1545–1452” in numerical order to the table.

Margaret Milner Richardson,  
*Commissioner of  
Internal Revenue.*

Approved November 28, 1995.

Leslie Samuels,  
*Assistant Secretary of  
the Treasury.*

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