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Issue

Whether § 263(g) requires the capitalization of Taxpayer's otherwise deductible payments or accruals (including interest and original issue discount) on its issued Indebtedness if Taxpayer has identified the Indebtedness as the item being hedged by Taxpayer's Derivative?

Law

Section 263(g)(1) provides that no deduction is allowed for interest and carrying charges properly allocable to personal property which is part of a straddle within the meaning of § 1092(c). Any amount disallowed under § 263(g)(1) is capitalized.

Section 263(g)(2) defines interest and carrying charges to mean interest on indebtedness incurred or continued to purchase or carry the personal property and certain other amounts paid or incurred to carry the personal property net of certain receipts with respect to the personal property.

Section 263(g)(3) carves out from the scope of § 263(g) any hedging transaction defined in § 1256(e).

Section 1256(e)(2) generally defines a hedging transaction as any hedging transaction (as defined in § 1221(b)(2)(A)), provided the taxpayer clearly identifies such transaction as being a hedging transaction before the close of the day on which such transaction was entered into (or such earlier time as the Secretary prescribes in regulations).

Section 1221(b)(2)(A) defines a hedging transaction as a transaction entered into by the taxpayer in the normal course of business primarily to manage risk of interest rate, price changes, or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings of the taxpayer.

Conclusion

Because Taxpayer’s Derivative manages currency fluctuations with respect to Taxpayer’s Indebtedness, and was identified as a hedge of Taxpayer’s Indebtedness, Taxpayer's payments or accruals, as described in § 263(g)(2), are not subject to section 263(g)(1).