

ordinary course of a trade or business. For purposes of the preceding sentence, the term *life insurance product* means a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract. See sections 72, 817, and 7702.

[T.D. 8700, 61 FR 67723, Dec. 24, 1996]

§ 1.475(c)-2 Definitions—security.

(a) *Items that are not securities.* The following items are not securities within the meaning of section 475(c)(2) with respect to a taxpayer and, therefore, are not subject to section 475—

(1) A security (determined without regard to this paragraph (a)) if section 1032 prevents the taxpayer from recognizing gain or loss with respect to that security;

(2) A debt instrument issued by the taxpayer (including a synthetic debt instrument, within the meaning of § 1.1275-6(b)(4), that § 1.1275-6(b) treats the taxpayer as having issued); or

(3) A REMIC residual interest, or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect, if the residual interest or the interest or arrangement is acquired on or after January 4, 1995.

(b) *Synthetic debt that § 1.1275-6(b) treats the taxpayer as holding.* If § 1.1275-6 treats a taxpayer as the holder of a synthetic debt instrument (within the meaning of § 1.1275-6(b)(4)), the synthetic debt instrument is a security held by the taxpayer within the meaning of section 475(c)(2)(C).

(c) *Negative value REMIC residuals acquired before January 4, 1995.* A REMIC residual interest that is described in paragraph (c)(1) of this section or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect is not a security within the meaning of section 475(c)(2).

(1) *Description.* A residual interest in a REMIC is described in this paragraph (c)(1) if, on the date the taxpayer acquires the residual interest, the present value of the anticipated tax liabilities associated with holding the interest exceeds the sum of—

(i) The present value of the expected future distributions on the interest; and

(ii) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(2) *Special rules applicable to negative value REMIC residuals acquired before January 4, 1995.* Solely for purposes of this paragraph (c)—

(i) If a transferee taxpayer acquires a residual interest with a basis determined by reference to the transferor's basis, then the transferee is deemed to acquire the interest on the date the transferor acquired it (or is deemed to acquire it under this paragraph (c)(2)(i)).

(ii) Anticipated tax liabilities, expected future distributions, and anticipated tax savings are determined under the rules in § 1.860E-2(a)(3) and without regard to the operation of section 475.

(iii) Present values are determined under the rules in § 1.860E-2(a)(4).

[T.D. 8700, 61 FR 67725, Dec. 24, 1996]

§ 1.475(d)-1 Character of gain or loss.

(a) *Securities never held in connection with the taxpayer's activities as a dealer in securities.* If a security is never held in connection with the taxpayer's activities as a dealer in securities, section 475(d)(3)(A) does not affect the character of gain or loss from the security, even if the taxpayer fails to identify the security under section 475(b)(2).

(b) *Ordinary treatment for notional principal contracts and derivatives held by dealers in notional principal contracts and derivatives.* Section 475(d)(3)(B)(ii) (concerning the character of gain or loss with respect to a security held by a person other than in connection with its activities as a dealer in securities) does not apply to a security if § 1.475(b)-1(c) and the absence of a determination by the Commissioner prevent section 475(b)(1)(A) from applying to the security.

[T.D. 8700, 61 FR 67725, Dec. 24, 1996]

§ 1.475(e)-1 Effective dates.

(a)-(b) [Reserved]

(c) Section 1.475(a)-3 (concerning acquisition by a dealer of a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

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(d) Except as provided elsewhere in this paragraph (d), §1.475(b)-1 (concerning the scope of exemptions from the mark-to-market requirement) applies to taxable years ending on or after December 31, 1993.

(1) Section 1.475(b)-1(b) applies as follows:

(i) Section 1.475(b)-1(b)(1)(i) (concerning equity interests issued by a related person) applies beginning June 19, 1996. If, on June 18, 1996, a security is subject to mark-to-market accounting and, on June 19, 1996, §1.475(b)-1(b)(1) begins to apply to the security solely because of the effective dates in this paragraph (d) (rather than because of a change in facts), then the rules of §1.475(b)-1(b)(4)(i)(A) (concerning the prohibition against marking) apply, but §1.475(b)-1(b)(4)(i)(B) (imposing a mark-to-market on the day before the onset of the prohibition) does not apply.

(ii) Section 1.475(b)-1(b)(2) (concerning relevant relationships for purposes of determining whether equity interests in related persons are prohibited from being marked to market) applies beginning June 19, 1996.

(iii) Section 1.475(b)-1(b)(3) (concerning certain actively traded securities) applies beginning June 19, 1996, to securities held on or after that date, except for securities described in §1.475(b)-1(e)(1)(i) (concerning equity interests issued by controlled entities). If a security is described in §1.475(b)-1(e)(1)(i), §1.475(b)-1(b)(3) applies only on or after January 23, 1997 if the security is held on or after that date. If §1.475(b)-1(b)(1) ceases to apply to a security by virtue of the operation of this paragraph (d)(1)(iii), the rules of §1.475(b)-1(b)(4)(ii) apply to the cessation.

(iv) Except to the extent provided in paragraph (d)(1) of this section, §1.475(b)-1(b)(4) (concerning changes in status) applies beginning June 19, 1996.

(2) Section 1.475(b)-1(c) (concerning securities deemed not held for investment by dealers in notional principal contracts and derivatives) applies to securities acquired on or after January 23, 1997.

(3) Section 1.475(b)-1(d) (concerning the special rule for hedges of another member's risk) is effective for securi-

ties acquired, originated, or entered into on or after January 23, 1997.

(e) Section 1.475(b)-2 (concerning identification of securities that are exempt from mark-to-market treatment) applies as follows:

(1) Section 1.475(b)-2(a) (concerning the general rules for identification of basis for exemption from mark to market treatment) applies to identifications made on or after July 1, 1997.

(2) Section 1.475(b)-2(b) (concerning time for identifying a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(3) Section 1.475(b)-2(c) (concerning identification in the context of integrated transactions under §1.1275-6) applies on and after August 13, 1996 (the effective date of §1.1275-6).

(f) [Reserved]

(g) Section 1.475(b)-4 (concerning transitional issues relating to exemptions) applies to taxable years ending on or after December 31, 1993.

(h) Section 1.475(c)-1 applies as follows:

(1) Except as otherwise provided in this paragraph (h)(1), §1.475(c)-1(a) (concerning the dealer-customer relationship) applies to taxable years beginning on or after January 1, 1995.

(i) [Reserved]

(ii) Section 1.475(c)-1(a)(2)(ii) (illustrating rules concerning the dealer-customer relationship) applies to taxable years beginning on or after June 20, 1996.

(iii)(A) Section 1.475(c)-1(a)(3) applies to taxable years beginning on or after June 20, 1996, except for transactions between members of the same consolidated group.

(B) For transactions between members of the same consolidated group, paragraph §1.475(c)-1(a)(3) applies to taxable years beginning on or after December 24, 1996.

(2) Section 1.475(c)-1(b) (concerning sellers of nonfinancial goods and services) applies to taxable years ending on or after December 31, 1993.

(3) Except as otherwise provided in this paragraph (h)(3), section 1.475(c)-1(c) (concerning taxpayers that purchase securities but engage in no more than negligible sales of the securities)

applies to taxable years ending on or after December 31, 1993.

(i) Section 1.475(c)-1(c)(3) (special rules for members of a consolidated group) is effective for taxable years beginning on or after December 24, 1996.

(ii) A taxpayer may rely on the rules set out in §1.475(c)-1T(b) (as contained in 26 CFR part 1 revised April 1, 1996) for taxable years beginning before January 23, 1997, provided the taxpayer applies that paragraph reasonably and consistently.

(4) Section 1.475(c)-1(d) (concerning the issuance of life insurance products) applies to taxable years beginning on or after January 1, 1995.

(i) Section 1.475(c)-2 (concerning the definition of security) applies to taxable years ending on or after December 31, 1993. By its terms, however, §1.475(c)-2(a)(3) applies only to residual interests or to interests or arrangements that are acquired on or after January 4, 1995; and the integrated transactions that are referred to in §§1.475(c)-2(a)(2) and 1.475(c)-2(b) exist only after August 13, 1996 (the effective date of §1.1275-6).

(j) Section 1.475(d)-1 (concerning the character of gain or loss) applies to taxable years ending on or after December 31, 1993.

[T.D. 8700, 61 FR 67725, Dec. 24, 1996]

ADJUSTMENTS

§ 1.481-1 Adjustments in general.

(a)(1) Section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. A change in method of accounting to which section 481 applies includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. For rules relating to changes in methods of accounting, see section 446(e) and paragraph (e) of §1.446-1. In computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts

from being duplicated or omitted. The "year of the change" is the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year.

(2) Unless the adjustments are attributable to a change in method of accounting initiated by the taxpayer, no part of the adjustments required by subparagraph (1) of this paragraph shall be based on amounts which were taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954 (hereinafter referred to as pre-1954 years).

(b) The adjustments specified in section 481(a) and this section shall take into account inventories, accounts receivable, accounts payable, and any other item determined to be necessary in order to prevent amounts from being duplicated or omitted.

(c)(1) The term "adjustments", as used in section 481, has reference to the net amount of the adjustments required by section 481(a) and paragraph (b) of this section. In the case of a change in the over-all method of accounting, such as from the cash receipts and disbursements method to an accrual method, the term "net amount of the adjustments" means the consolidation of adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in various accounts, such as inventory, accounts receivable, and accounts payable, at the beginning of the taxable year of the change in method of accounting. With respect to the portion of the adjustments attributable to pre-1954 years, it is immaterial that the same items or class of items with respect to which adjustments would have to be made (for the first taxable year to which section 481 applies) do not exist at the time the actual change in method of accounting occurs. For purposes of section 481, only the net dollar balance is to be taken into account. In the case of a change in the treatment of a single material item, the amount of the adjustment shall be determined