

## Examining the Straddle Rules After 25 Years

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In 1984, the Tax Equity and Fiscal Responsibility Act revised the straddle rules to close perceived loopholes. The pros and cons of the straddle rules have been debated for years. To commemorate the 25th anniversary of the expanded straddle rules, experts from different areas of the tax world — including Edward D. Kleinbard, David Weisbach, William M. Paul, Mark H. Leeds, and Lee A. Sheppard — weigh in with their thoughts on the regulations.

The views expressed herein are the views of the individual authors and do not necessarily reflect those of the institutions with which they are affiliated.

### Table of Contents

<b>I.</b>	<b>Introduction</b> . . . . .	1301
<b>II.</b>	<b>Policy Perspectives</b> . . . . .	1301
	A. Systematic Underinvestment in Straddle Rules . . . . .	1301
	B. A Hedge Timing Alternative . . . . .	1302
	C. Mark to Market for Simplification . . . . .	1303
	D. Stock Straddle Rules Make No Sense . . . . .	1304
	E. Eliminate Overbreadth but Keep Effective . . . . .	1305
	F. So What Did Congress Mean With 263(g)? . . . . .	1306
	G. Have Straddles Swallowed Short Sales? . . . . .	1308
<b>III.</b>	<b>Harshness of the Results</b> . . . . .	1309
	A. Unintended Consequences . . . . .	1309
	B. Frustration and the Straddle Rules . . . . .	1309
<b>IV.</b>	<b>Straddle Concepts</b> . . . . .	1310
	A. Defining 'Position' Isn't Always Easy . . . . .	1310

	B. Diminishing the Reach of the Straddle Rules . . . . .	1311
	C. Explaining Risk Reduction . . . . .	1312
	D. Unbalanced Positions in Straddles . . . . .	1313
	E. What Is Part of a Larger Straddle? . . . . .	1314
<b>V.</b>	<b>Foreign Currency</b> . . . . .	1315
	A. 1256 and Currency Contracts: It's a Mess Inside . . . . .	1315
	B. Exempting Foreign Currency Losses . . . . .	1317
<b>VI.</b>	<b>Accounting</b> . . . . .	1317
	A. Identified and Unidentified Straddles . . . . .	1317
	B. Rational Limits of Offsetting Positions . . . . .	1318
	C. Gain or Loss on Termination . . . . .	1319

### I. Introduction

*By Robert Gordon and John Ensminger*

The 25th anniversary of the expanded straddle rules got us thinking about the impact the 1984 revisions had on taxpayers. Many have voiced their frustrations with implementing the straddle rules, while others are just frustrated with the unintended consequences that arise when applying the rules. We invited many of the thought leaders involved with the taxation of financial products to share their observations and pet peeves. Those who found the time for such an amusement participated. The following is a compilation of those submissions.

### II. Policy Perspectives

#### A. Systematic Underinvestment in Straddle Rules

*By Edward D. Kleinbard*

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Our system for taxing capital income has at its core four noneconomic axioms: the distinction between debt and equity, the distinction between corporate and non-corporate enterprises, the distinction between capital gain and ordinary income, and the realization principle. Of these, the realization principle has the longest pedigree in academic commentary, attributable to the confusion in the earliest years of the income tax over whether the doctrine represented a rule of convenience or a constitutional imperative.

We all recognize the damage done by the realization principle: The doctrine vitiates our ability to measure returns to capital in general; it drives the "lock-in" effect that induces investors to hold investments that they would prefer to sell; and it facilitates tax minimization strategies through the current recognition of losses and the deferral of accrued gains. A frontal assault on the

realization principle may not be feasible, but the focus of Congress, Treasury, and the IRS at every turn should be to circumscribe its application to the most exigent circumstances.

As conceived in 1981, the straddle rules directly responded to the distortions in income measurement that would follow from a literal application of the realization principle, both through their loss deferral rule and their reinvention of wash sale principles. (The straddle rules' short sale principles also are crucial, but address character rather than realization; the expense capitalization rule of section 263(g) addresses realization-related concerns, but was intended to be ancillary to the major themes of loss deferral and wash sales.) These principles ensured that capital income taxation would not be rendered wholly optional through the current recognition of loss and the deferral of offsetting gain. Since 1981, the straddle rules have only gained in relevance with the advent of more varieties of derivative financial instruments and more liquidity in the derivatives markets, because both make the core straddling strategy easier to implement.

In light of the critical role that the straddle rules were designed to play in containing the realization doctrine, one would expect that the tax administration would devote substantial resources to their articulation and enforcement, but the opposite has been the case. The core straddle regulations have remained in temporary form for more than a quarter-century. More strikingly, there is no administrative guidance at all about how much reduction in risk constitutes a "substantial diminution" — that is, how offsetting is offsetting. Does being short a two-year bond substantially diminish the risk of being long a 10-year bond? What about being short five two-year bonds? And one would look in vain for any evidence in the litigation record of the vigorous enforcement of the straddle rules in any interesting circumstances.

Consider Rev. Rul. 2000-12.<sup>1</sup> That ruling addressed a paradigmatic straddle problem in which a taxpayer was long and short the same risk through the purchase of two bonds (a bull and bear pair). When the underlying risk event occurred (before the maturity of the instruments), the taxpayer relied on the realization principle to accelerate loss while deferring offsetting gain. Instead of responding by invoking the straddle rules — the weapon that Congress developed to block exactly this transaction — the IRS sought to disallow the "artificial loss" (in the words of the ruling) by relying on ambiguous economic substance principles and an arguably aggressive reading of its integration authority under the original issue discount rules.

The result was an implicit deprecation of the central role of the straddle rules. Why? In the facts, the IRS noted that the underlying risk did not relate to actively traded personal property and that the bonds were "privately placed." For these reasons, the IRS implicitly signaled, the straddle rules were inadequate to the task for which they were designed. But this reading is inconsistent with the construction of section 1092, which was designed to

incorporate within the straddle rules not simply actively traded instruments, but instruments that are "of a type" (not "of a class") that is actively traded. Privately placed contingent interest bonds are of a type that is actively traded, because the *type* is contingent interest bonds, and there are plenty of examples of publicly traded contingent interest debt instruments.

If the response is that a broad reading of the phrase "of a type" along the lines I have suggested would sweep into the straddle rules almost every debt instrument in the world, my retort would be, "Yes, precisely." Can there be any doubt that the transaction at issue in Rev. Rul. 2000-12 was a straddle in every straightforward sense? Why, then, rely on attenuated OID integration arguments that in turn invite engineering workarounds and at the same time read out of the code a phrase ("of a type") deliberately chosen to give the straddle rules as broad an application as possible?

These are wounds that the tax administration has inflicted on itself. Congress gave Treasury and the IRS a robust statute and adequate regulatory authority to pursue an ambitious reading of the scope of the straddle rules, but the tax administrators have largely done the opposite. The straddle rules are now understood as the province of financial product tax wonks, not the principal tool for containing the pernicious realization principle.

It is time for Treasury and the IRS to reverse course and use the straddle rules to shepherd all sophisticated taxpayers into the corral of section 475(f) mark-to-market elections, where, by definition, gaming of the realization principle cannot apply. To do so, Treasury must both interpret the straddle rules aggressively and make clear that the mark-to-market sanctuary of section 475(f) welcomes all, without great investigation into how much activity constitutes a trade or business for that purpose. This is the result that economics encourages and that Congress anticipated.

## B. A Hedge Timing Alternative

By William M. Paul

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I had the good fortune to work on the 1984 amendments to the straddle rules. It was one of my earliest projects in the tax area, and it was such an interesting and enjoyable experience that it helped cement my decision to become a tax lawyer. Eddie Cohen and I represented the Pacific Stock Exchange, which at that time had a substantial options trading floor in San Francisco. We were part of a working group of tax lawyers representing the various options exchanges — the Chicago Board Options Exchange, the American Stock Exchange, and the Philadelphia Stock Exchange, along with the Pacific Stock Exchange. This coalition worked closely with Treasury and Capitol Hill staff to address concerns about the use of tax straddles involving options, without impinging unduly on common, non-tax-motivated options strategies, most notably the writing of covered calls.

Section 1092 was enacted in 1981 primarily to address the use of futures contracts to create artificial losses

<sup>1</sup>2000-1 C.B. 744, Doc 2000-5720, 2000 TNT 40-21.

through the use of economically offsetting positions. Although the 1981 act did not apply the straddle rules to listed options and stock, the options exchanges made a commitment to work with Congress to devise appropriate legislation if straddling with listed options became a problem, which it did. Our coalition worked to fulfill the exchanges' commitment to Congress.

Like most other antiabuse provisions, the straddle rules are antitaxpayer; they are essentially "don't do this" rules. They do not attempt to achieve clear reflection of income. In a crude way, the straddle rules apply hedge timing principles when they are adverse to the taxpayer (losses recognized first), but not when they would be favorable to the taxpayer (gains recognized first).

In some contexts — namely when abusive transactions would not take place but for (anticipated) tax benefits — antitaxpayer "don't do this" rules may well reflect sound tax policy. However, when there are substantial nontax reasons to enter into particular types of transactions, that approach creates inefficiencies because taxpayers either refrain from entering into those transactions and suffer the adverse economic consequences, or they enter into substitute transactions that are less effective in obtaining the desired economic benefits but avoid adverse tax consequences.

Today, unlike 25 years ago, we have relatively well-developed rules for business hedges, which evenhandedly provide for matched timing of gains and losses on the hedge and the hedged item. The hedging rules include upfront identification requirements that are designed to protect the government against post hoc determinations by the taxpayer. As in the business context, there are legitimate nontax reasons why taxpayers holding stock or other publicly traded positions may decide to hedge those positions. Nonetheless, these hedges do not qualify for hedge timing (or other hedge treatment) available to business hedges because the positions in question are not entered into in the ordinary course of a trade or business and because they give rise to capital gains and losses. In principle, it is unclear why an antitaxpayer rule should apply to these hedges when a hedge timing approach — under which gains and losses from the offsetting positions are taken into account in the same time frame — would adequately protect the government from the abuse that section 1092 is intended to prevent.

Active traders can elect mark-to-market treatment under section 475(f) and avoid application of the straddle rules (and the wash sale rules). However, the IRS requires a very high level of trading activity before it will permit a taxpayer to qualify for the election. That leaves most people who are active investors no ability to hedge their portfolio positions without subjecting themselves to the punitive straddle rules.

A clear-reflection or hedge timing approach to hedges of publicly traded stock (and other positions subject to section 1092) would reflect better tax policy than current section 1092. I believe the only concern — and it is not

trivial<sup>2</sup> — is whether such an approach would be unduly subject to gaming by taxpayers. We have already crossed that bridge to some extent with the 2004 expansion of the "identified straddle" rules in section 1092(a)(2). The recent expansion of information reporting to include basis reporting might constrain inappropriate behavior, and additional reporting by taxpayers seeking hedge timing for straddle gains and losses could be required. Taxpayers wishing to use hedge timing for straddles could be required to provide an upfront identification to their broker and receive written confirmation from the broker of the positions that make up the straddle.<sup>3</sup> Perhaps taxpayers wishing to receive hedge timing for straddle positions could be required to mark the positions to market.<sup>4</sup> In any event, developing a workable hedge timing regime for straddles would be worth the effort.

### C. Mark to Market for Simplification

By Lee A. Sheppard

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The straddle rules are rather like the offside rule in football (that'd be the game with the round ball the rest of the world calls football): seemingly antiquated, kinda silly, and difficult to enforce without a lot of expensive hardware, but nonetheless a fundamental part of the game.

The case against the straddle rules appears to be basically that they are a nuisance for portfolio managers who don't want to spend any more time with tax practitioners than they absolutely have to. Investment managers see tax compliance as a deadweight economic loss; unlike some corporations, they're not mining the code for earnings. I'm not hugely sympathetic to the tax compliance whinges of folks who run billions of dollars and rent office space in London.

In an era when Congress acts to shut down offensive transactions by writing extremely narrow provisions that are pointless the day they become effective, the resilience of the straddle rules is impressive. Without meaning to do so, Congress enacted a broad set of provisions that have application well beyond the original transactions.

It is, of course, argued that the original straddles are long gone, and that the straddle rules are antiquated and serve mainly to catch things that inevitably occur in large portfolios. But without them, straddles would deliberately occur in large portfolios and nothing could be done. The tax law has an interest in broadly identifying offsetting positions, because the tax law needs to ensure that taxpayers have risk in their positions.

<sup>2</sup>For purposes of this tax policy discussion, I am ignoring revenue effects.

<sup>3</sup>*Cf.* reg. section 1.1012-1(c)(3) (documentation requirements for using "specific identification" method to determine basis in stock sold).

<sup>4</sup>Under this approach, any gain or loss accruing economically on a position before the position became part of the straddle would be suspended.

The tax law needs to be able to say that a taxpayer that is not economically at risk on an asset is not the tax owner of the asset, even when the taxpayer is the legal owner. The straddle rules are part of that effort, just like the wash sale rules. Offsets should mean either that there is no tax ownership or that the taxpayer in question should be forced into mark-to-market accounting.

The straddle rules were narrowly directed at shutting down commodities straddles, a tax shelter common among Chicago commodities dealers and traders that found its way to retail investors. (No tax shelter can survive retail distribution.) The shelter involved putting on offsetting futures contracts, selectively selling the losing side, taking the loss, and rolling the winning side forward into the subsequent tax year.

The solution was to require offsetting regulated futures contracts and other contracts to be marked to market at the end of each tax year, as is done for financial accounting purposes (section 1256). If contracts are identified as hedges, they are exempt from being marked to market (section 1256(e)(2)). Marking to market was regarded as a simple solution because the exchanges were already doing daily marking and there was an established market to set prices for most of the contracts concerned. (See Statement of Financial Accounting Standards No. 80, "Accounting for Futures Contracts.")

Section 1256 is a vehicle whose reach should be expanded to everything for which a price can be derived. The tax administrator has the power to make a lot of this happen, because the definition of regulated futures contract merely requires marking and exchange trading. And there do not appear to be many constraints on the type of market that the tax administrator can designate as a qualified exchange.

Losses must be deferred until both sides of the contract are closed out (section 1092). The straddle rules toll holding periods and require capitalization of expenses. There are also special reporting rules. Costs of straddles were required to be capitalized (section 263(g)). These rules do not apply to hedges, which require an ordinary asset used in a trade or business plus identification (sections 1221(b)(2)(A) and 1256(e)). Numerous rulings demonstrate that the IRS likes to argue economic substance to defer losses when offsets slip through the straddle rules.

It is argued that the loss deferral rule of section 1092 is unenforceable because huge portfolios inevitably contain straddles that cannot be easily identified. Sophisticated computer programs are being developed to identify straddles in giant portfolios. Why should we be troubled by this? People who manage huge portfolios know on a minute-by-minute basis what their positions are and whether they are offset. Asking them to harness their computer power to comply with the tax law is not too burdensome. Finding straddles buried in portfolios may not have been the original intent of the law, but without a blanket application, straddles could be and would be buried in portfolios. Portfolio hedging and business hedging are two different things.

Section 1092 asks whether a taxpayer has achieved a substantial diminution of risk for a position that does not qualify, and was not identified, as a hedge. If the law defined substantial diminution of risk the way the section

246 rules do, we would end up defying economic reality. The prices of shares in particular industries do positively correlate, unless one firm is really a mess, and because most gains in shares are inflationary. (Is it fair to tax inflationary gains? Yes, absolutely.) The section 246 rules are very generous in what they say are not offsetting positions.

Electing traders under section 475(f) are exempt from the straddle rules. Why aren't more funds allowed to elect section 475(f)? I find it hard to believe that any actively managed fund is not doing enough trading to qualify. Moreover, the tax law should want them (and everyone else) to mark. Traders and large investors should be required to mark.

The IRS is stingy with section 475(f) elections, which makes some sense in the case of individual investors making last-minute elections to take losses. Broker reporting eventually could both simplify enforcement and make elections more practical, so election could be broadly opened up to individuals. Realistically, no individual investor who holds investments in taxable form can be described as "little" or an object of sympathy.

If these individual investors want collars and married puts and floors (offsets other than qualified covered call options), let them recognize gain or mark their portfolios to market. Should hedge accounting be permitted for individuals? No, because as investors, they rarely have trades or businesses, and because putting them on a marking regime would be simpler.

The IRS has not seen the light on section 475. It generally treats mark-to-market accounting as a tax benefit rather than as a tax law adjunct to the absolute necessity of achieving some semblance of veracity in financial reporting. In football, the often judgmental line between on- and offside is called "the line of truth." Mark-to-market accounting is the line of truth. It's the best we can do. If we don't mark, the books are works of fiction.

Could the whole mess of the straddle rules be vastly simplified? Yes, of course, like everything else in the tax code. Practitioners might not enjoy the simple version because it would remove the little escape hatches for realization taxpayers using effective offsets for their positions.

Simplification ideally would force every sizable investor to mark to market, or, if the realization requirement were maintained, simplification would require recognition when any effective offset was incurred for the position in question. A simplified rule would define effective offset broadly, including partial offsets. The ineffectual rules of sections 1259 and 1260 should be reconsidered and made to function as intended if the realization requirement is maintained.

#### **D. Stock Straddle Rules Make No Sense**

*By David Weisbach*

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One of my first projects when I arrived at Treasury in 1992 was to assist in drafting the regulations under

sections 246(c)(4)(C) and 1092, defining substantially similar or related property. We faced several dilemmas.

First, it was clear from the statute and legislative history that the term had to mean the same thing in the two sections. The underlying policy concerns, however, were completely different. Holding a dividend-paying stock and hedging out the risk did not seem to raise any particular tax avoidance issues. Although Congress, in its wisdom, had decided that taxpayers should not receive the dividends received deduction if they did this, it was hard to see the problem with a simple and relatively narrow approach to section 246(c). The straddle rules, however, presented serious problems. A narrow definition could lead to the traditional straddle abuses.

Second, the straddle rules, as then in effect, could produce harsh results for taxpayers making ordinary adjustments to portfolio risk. Losses were denied to the extent of built-in gains in the straddle. If a taxpayer with a large portfolio temporarily adjusted its market exposure through a short index futures contract, losses on the futures would be deferred to the extent of built-in gains in the entire portfolio, which could mean indefinite deferral. Ordinary, non-tax-motivated transactions therefore triggered unnecessarily harsh consequences if we issued a broad rule. Transactions no ordinary person would suspect to be a straddle would not only get caught, but also produce harsh tax consequences.

Finally, Congress seemed to think that there were easy-to-administer notions of "similar" in a modern financial world of factor models and the like, as if financial instruments were like Toyotas and Hondas. We felt constrained not to incorporate complex financial models or modern portfolio theory into tax regulations. Nevertheless, Congress informed us in the legislative history that several transactions were to be covered, and it was entirely unclear how to cover those transactions without modern financial theory.

Faced with these problems, we came up with the 70 percent overlap rule for portfolios: Taxpayers simply count stocks in a portfolio and stocks in the hedge, and there is a straddle only if they have 70 percent overlap. It is a simple test, but it is entirely divorced from the economics. Looking back after more than 15 years, it is not at all clear that the test makes any sense. It is easy to get around and may still catch innocent taxpayers unaware. And even though it is simple, the test is often difficult to apply to complex trading strategies that combine stocks and other instruments. We added an inscrutable antiabuse rule, which perhaps helps reduce avoidance a bit, but it is, well, inscrutable.

In the meantime, Congress repealed the stock exception to the straddle rules and changed the identified straddle rules in an attempt to fix the permanent loss denial problem. The new identified straddle rules, however, are a mess, and Congress kept the substantially similar and related property definition tied to the unrelated policy concerns of section 246(c). Rather than improve the operation of the rules, the recent changes seem only to have made them worse.

It is one thing to see marketed commodity straddle transactions and know that losses in those circumstances should not be allowed. It is an entirely different thing to decide when losses are appropriate within a large port-

folio, possibly spread across several related entities, traded with various strategies, some possibly tax motivated and many not. Trying to identify straddles — transactions linked to one another through risk reduction — within a large portfolio simply makes no sense. Trades may be related to one another, but they also always take place as part of a larger portfolio. It is not easy, however, to separate the two cases: If trades within large portfolios were not covered, it would be easy to hide old-school straddle abuses within portfolios. It is time for a new approach.

The key question is when a taxpayer should be allowed trading losses. One answer is that to the extent a taxpayer has built-in gains, the losses should not be allowed because we know the taxpayer has not lost money. Or, if one takes annual accounting seriously, perhaps it would be best to say losses should not be allowed to the extent of built-in gains arising during the tax year. Alternatively, in the ordinary course we allow losses against realized gains, and there is no reason why this rule should not apply when a taxpayer happens to be long and short instead of holding two longs. I can imagine arguments for any of these approaches, alternative approaches, linear combinations of these approaches, or any of the above limited to taxpayers with sufficiently large holdings. Looking back, I'm not sure what I would have done differently, but it is clear that we have ended up with rules that make no sense at all.

### E. Eliminate Overbreadth but Keep Effective

By Jeffrey Maddrey and John Kaufmann

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The straddle rules function well as antiabuse rules to prevent the type of transactions they were designed to prevent — that is, tax-motivated, risk-free transactions in publicly traded property entered into for the purpose of accelerating taxable loss, deferring taxable gain, and changing what would otherwise be ordinary income to capital gain. However, they are overbroad. As a result, their application as substantive tax accounting rules can cause taxpayers who engage in legitimate transactions that happen to involve offsetting positions in personal property to be subject to punitive, unintended consequences. For example, in many cases the straddle rules can force a taxpayer who realizes gain and loss in the same period with respect to offsetting positions to currently recognize the gain but to defer the recognition of the naturally offsetting realized loss.<sup>5</sup> In some situations,

<sup>5</sup>To take just one example, consider a taxpayer that seeks to partially hedge a long position in personal property by purchasing a put option (an economically short and therefore offsetting position) that covers 30 percent of the long position. Assume further that (1) the put expires unexercised (resulting in a realized loss equal to the premium paid), (2) 30 percent of the long position is sold (resulting in a realized gain equal to or greater than the loss on the put), and (3) the remaining portion of the long position is held at the end of the tax year at an

(Footnote continued on next page.)

this effect can result in taxable income for the current period far in excess of economic income.

The problem here is not really the logic of the straddle rules — a robust system of loss deferral is necessary to address the abusive situations that originally gave rise to the rules — but their effective scope: The straddle rules should not apply to legitimate non-tax-motivated transactions that merely happen to involve offsetting positions in actively traded personal property (that is, those that were initiated with the intention of generating a profit in a manner that is often wholly ignorant of tax considerations, not for the purposes of risklessly achieving a tax result). Unfortunately, the straddle rules apply to too many of these situations, because of the relatively limited scope of the business hedging rules of reg. sections 1.1221-2 and 1.446-4 and the elective mark-to-market provisions of section 475(e) and (f).

Section 1092(e) and the business hedging rules of reg. sections 1.1221-2 and 1.446-4 provide a tax accounting regime for offsetting positions that, when it applies, trumps the straddle rules. Generally, section 1092(e) exempts hedging transactions (as defined in section 1256(e)) from the application of the straddle rules. Section 1256(e)(2) defines a hedging transaction by reference to section 1221(b)(2)(A). Regulations under section 1221(b)(2)(A) define a tax hedging transaction as a transaction that manages the risk of interest rate, price, or currency fluctuations for “ordinary property,” or “ordinary obligations.”<sup>6</sup> For these purposes, ordinary property is property a sale or exchange of which can only give rise to ordinary gain or loss, and an ordinary obligation is an obligation performance or termination of which can only give rise to ordinary income, deduction, gain, or loss.<sup>7</sup> Under the hedge timing rules, items of income, deduction, gain, or loss from tax hedging transactions are taken into account in the same period or periods as those from the hedged item.<sup>8</sup> The effect, for transactions within their scope, is to ensure that economically offsetting transactions are tax accounted for on a rational, clearly reflective basis. Because the rules symmetrically time the recognition of tax items from both offsetting legs, they ensure that taxable income better tracks economic income.

Unfortunately, because the business hedging rules apply only to hedges of ordinary property or ordinary obligations, their scope is limited. For example, the business hedging rules do not apply to risk management transactions concerning capital assets, including, most significantly, transactions designed to offset the price risk of a portfolio of debt instruments held by an insurance company or by a bond-oriented hedge or private equity fund. If the risk management transactions that these taxpayers undertake rise to the level of straddles, they can get into situations in which gains and losses are

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unrealized gain. Unless an “identified straddle” election has been made, under the so-called last-dollar rule the taxpayer must recognize the gain on the 30 percent disposition while deferring the economically offsetting loss on the 30 percent put.

<sup>6</sup>Reg. section 1.1221-2(b).

<sup>7</sup>Reg. section 1.1221-2(c)(2).

<sup>8</sup>Reg. section 1.446-4(b).

realized in the current year at about the same rate but the recognition of losses is deferred because of the existence of unrealized gains elsewhere in the portfolio.

The elective mark-to-market provisions of section 475(e) and (f) were designed in 1997 to be an out from the overbreadth of the straddle rules. A taxpayer with high-frequency security or commodity trading may prefer to simply be taxed at ordinary rates on economic income (determined on a mark-to-market basis) rather than be in a situation in which realized gains are subject to current tax while economically offsetting realized losses are subject to deferral under the straddle rules. For taxpayers who choose to mark to market their entire business, section 475(e) and (f) have proven useful. However, for others these elective outs are unavailable because the straddle rules may still apply to a portion of the taxpayer’s portfolio. For example, consider a taxpayer that (1) sells a commodity in the chain of commerce (for example, oil, gas, coal, timber, or electricity); (2) manages its price risk associated with its purchases and sales through economically offsetting financial derivatives in that commodity; and (3) also runs a separate, proprietary trading business that speculates in the financial derivatives otherwise used to hedge. Although it is possible to elect to tax account for the separate proprietary business on a mark-to-market basis under section 475(f), the straddle rules could still apply to defer losses inside the mark-to-market business when there are unrealized gains outside the mark-to-market business.<sup>9</sup> Significantly, the straddle effect cannot be avoided by walling off that business in a separate consolidated group member or partnership.<sup>10</sup>

How to eliminate the overbreadth of the straddle rules as tax accounting rules without causing them to lose their effectiveness as antiabuse rules? Two positive steps would be for Congress and Treasury to expand the scope of the business hedging regime to cover more common fact patterns (including, for example, non-tax-motivated portfolio hedges) and to limit the ability of the straddle rules to reach into a mark-to-market book that is operated separately from the taxpayer’s nonmarked businesses.

## F. So What Did Congress Mean With 263(g)?

By *Yoram Keinan*

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Section 263(g), a statutory antiabuse provision closely related to section 1092, is another example of a controversial and unfinished aspect of the crippled straddle rules. It is critical, as a part of an overall guidance, to address this provision.

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<sup>9</sup>The parenthetical in section 475(d)(1) makes clear that straddle rules are not turned off by mark-to-market accounting under section 475.

<sup>10</sup>See section 1092(d)(4)(B) and (C).

Section 263(g) was enacted in 1981 in response to cash-and-carry transactions. In such a typical transaction, as illustrated in the legislative history of section 263(g), on January 1, 1981, a taxpayer borrowed \$100,000 for 24 months and used the proceeds to buy 1,000 ounces of gold at \$100 an ounce. Simultaneously, the taxpayer entered into a forward contract to sell 1,000 ounces of gold in two years at \$120 per ounce. The long and short positions in the gold would be a straddle. The yield to maturity on the loan was 10 percent, payable only at maturity (that is, zero coupon debt), and the other costs associated with holding the long position in the gold for 24 months were \$2 per ounce, which was payable at the end of the second year. Thus, at the end of the two-year period, the taxpayer would owe \$121,000 on the loan and \$2,000 of other costs (for a total of \$123,000 liability), but would receive \$120,000 on the forward contract. In the absence of a tax benefit, the overall result for the taxpayer from the loan, the long position in the gold (plus associated costs), and the forward contract would be a net loss of \$3,000.

Before the enactment of section 263(g), however, the taxpayer could deduct the 10 percent of interest over the life of the loan as it accrued and realize a long-term capital gain of \$20,000 on the sale of the gold under the forward contract, but only on the maturity of that contract on January 1, 2011. Thus, because the interest was deductible currently while the gain on the forward was deferred, the taxpayer would make an after-tax profit. Further, the gain on the forward contract would be long-term capital gain subject to lower tax rates, while the interest deduction, which was ordinary, could be used to offset the taxpayer's other sources of ordinary income.

Congress responded to this potential abuse by enacting section 263(g) (and it specifically stated that the statute was enacted in response to those transactions). Under section 263(g), interest and carrying charges allocable to personal property held as an offsetting position of a straddle must be capitalized. Thus, as a threshold matter, section 263(g) is triggered only if a straddle exists. Similar to the test under section 265 (leveraged tax-exempt bonds), the crucial question is whether a debt was "incurred or continued to purchase or carry" a position in a straddle.<sup>11</sup> Therefore, under the plain language of the code, not only must a straddle exist (that is, two offsetting positions), but the loan must be incurred or continued to purchase or carry a leg in that straddle. Stated differently, there must be two offsetting positions, and the debt must be issued or continued to purchase or carry one of those positions.

If section 263(g) applies to a loan, the interest thereon must be charged to the capital account of the property to

<sup>11</sup>See also sections 1277 (debt incurred or continued to purchase or carry a market discount bond) and 1281 (debt incurred or continued to purchase or carry a short-term obligation), both using the identical test.

which the interest relates, thereby reducing the gain or increasing the loss recognized on the disposition of the property.<sup>12</sup>

It was clear from the legislative history and the plain language of the statute that Congress was mostly concerned with transactions similar to the cash-and-carry transaction described above. However, proposed regulations under section 263(g) were issued on January 17, 2001, that, if adopted, would expand the scope of section 263(g) beyond its original purpose. The proposed regulations contain a regulation under section 1092(d) providing that a taxpayer's exchangeable debt instrument with payments linked to the value of personal property is a position in that property. A popular type of that instrument was PHONES, in which an issuer issued exchangeable senior unsecured debt instruments exchangeable at the holder's option at any time for an amount of cash equal to a percentage of the value of a portfolio stock. The terms of the instrument provided for interest to be paid quarterly and for additional interest to be paid if the corporation paid cash dividends. The issuer accrued interest under the contingent payment debt instrument regulations.

The initial question regarding that debt (and whether the proposed regulations are correct in their application to PHONES) is whether the debt and portfolio stock constitute a straddle. This raises many issues that are discussed elsewhere in this report. Assuming for now that PHONES is a straddle, the proposed regulations would establish that the debt in this case carries the personal property (to which the payments are linked) and that interest on the debt would therefore be deferred.<sup>13</sup> In other words, the proposed regulations would limit the interest on the debt even if the debt itself is the leg in the straddle.

While the proposed regulations were strongly criticized by many commentators, the IRS continued to believe that the positions it took in them was correct, especially in the context of PHONES and similar types of transactions. Thus, even though the regulations were far from being finalized and adopted then (and they are likely still far from being adopted), the IRS issued two private letter rulings in 2004 and 2005 that dealt with PHONES transactions, and it ruled in accordance with the position of the proposed regulations that interest on the debt must be capitalized under section 263(g). The

<sup>12</sup>The term "interest and carrying charges" means the excess of (1) interest on indebtedness incurred or continued to purchase or carry the personal property (including personal property used in a short sale), and (2) any noninterest charges (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property, over (A) any interest income with respect to the personal property (including some market and acquisition discounts for bonds, and any compensating payments made to the lender of securities used in a short sale), and (B) any dividends (reduced by the dividends received deductions) on stock included in a straddle.

<sup>13</sup>Expansion of section 163(l) in the 2004 act makes this issue moot, at least for stock, because interest would be disallowed rather than capitalized.

IRS concluded in both rulings that the instruments constitute a position under section 1092(d)(2) and are part of a straddle with the underlying reference stock, and that payments by the issuer are nondeductible interest and carrying charges under section 263(g).

In concluding that the instruments were positions in straddles, the IRS reasoned that although a debtor's obligation on a debt instrument generally is not personal property, in some circumstances it may be considered a position. The IRS observed that the instrument by its own terms created an interest or position in the portfolio stock. The IRS concluded that the instruments constitute a position respecting substantially similar or related property as a result of, among other factors, the economics of the instruments and the contingent payment schedule.

The IRS then concluded that the circumstances surrounding the issuance of the instruments were directly related to carrying the corporation's stock, despite the taxpayer's claims that the proceeds were used for business development and other investments, such as paying outstanding debt.

The letter rulings, which effectively treated the controversial proposed regulations as a done deal, simply added to the criticism of those regulations.

In my view, it is necessary to put together guidance under section 263(g). In particular, it is necessary to settle once and for all what is meant by the phrase "incurred or continued to purchase or carry." Several antiabuse provisions in the code use this same test, but the only guidance the IRS has issued on how to apply the test is a revenue procedure from 1972.<sup>14</sup> While I urge Treasury and the IRS to continue their efforts to provide guidance on the straddle rules in general and section 263(g) in particular, I also urge them to remain within the four corners of the legislative history and the mandate given in the statute for those regulations. Many practitioners and commentators have pointed out that the proposed regulations went beyond the legislative history and the plain language of the statute, and that eight years have passed with no sign of finalizing the regulations is a clear sign that they should be carefully revisited.

### G. Have Straddles Swallowed Short Sales?

By Erika Nijenhuis

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As code provisions go, on balance I'd say the straddle rules deserve a grade of about a B. On clarity of drafting and amount of guidance, they rank lower. But they've been pretty effective at shutting down the transactions they were aimed at, without wreaking too much havoc

<sup>14</sup>Rev. Proc. 72-18, 1972-1 C.B. 740. Several court cases deal with this test in the context of section 265. Practitioners and commentators generally rely on Rev. Proc. 72-18 and the court cases on section 265 in applying this test to sections 263(g), 1277, and 1281.

on transactions that weren't intended to be captured. And that is about as much as one can reasonably expect.

Perhaps we should be wary of asking for more. The last substantive changes to the straddle rules — the amendments to section 1092 in 2004 — could fairly be viewed as making things less, not more, clear regarding the definition of what constitutes a straddle, which is a pretty essential component of the provision. In particular, the straddle rules now appear to have superseded the short sale rules of section 1233 not only for married puts, but also with respect to the core provision that the short sales are aimed at — namely, a short-against-the-box transaction (a transaction in which the taxpayer holds long stock and simultaneously sells the same stock short). This can hardly be what Congress intended. And I suspect that most readers of the short sale rules believe those rules still apply to short-against-the-box transactions.

You might think that not much turns on whether section 1233 or 1092 applies, since the mandatory gain recognition required by the constructive sale rules has dampened interest in short-against-the-box transactions. But even if a short-against-the-box transaction gives rise to a constructive sale, one might want to know how the transaction is taxed thereafter.

The source of confusion is that the special rules for stock under section 1092(d)(3) were amended in 2004 to generally treat a transaction in which a taxpayer holds actively traded stock and an offsetting position as a straddle. A short-against-the-box transaction obviously fits that description. And section 1233(c)(2)(A) provides that "property" for section 1233 purposes does not include any position to which section 1092(b) applies. That is, where both could apply, section 1092 generally trumps section 1233. Yet that can't possibly be right in this case. The legislative history of the 2004 amendments to section 1092(d)(3) doesn't say that section 1233 is being largely written out of the code; those amendments were intended to be primarily technical and clarifying changes.<sup>15</sup>

So why do we care, anyway? It turns out that there are several potentially significant reasons. For example, the special rules that were added in 2004 that eliminate taxpayers' ability to use self-help to effectively avoid the unfair matching of straddle period losses against pre-straddle-period gains by delivering the stock to close a straddle position (section 1092(d)(8)) apply only under section 1092, not section 1233. Section 263(g) applies only to section 1092 straddles and not to section 1233 short sales. And the holding period rules work differently under the two sections as well.<sup>16</sup>

It is all the more maddening that this situation is the result of what was intended just to be the elimination of

<sup>15</sup>The pre-2004 version of section 1092(d)(3) had an obscure carveout in a parenthetical that excluded short-against-the-box transactions from its scope. The carveout was unintelligible unless you already knew what it meant, but at least it was there. (See the text above regarding the lack of clarity in drafting.) The carveout was eliminated in 2004 as an incidental side effect of the rewording of section 1092(d)(3).

<sup>16</sup>For more on this topic, see Erika Nijenhuis, "Taxation of Securities Futures Contracts," in *Tax Strategies for Corporate* (Footnote continued on next page.)

deadwood in section 1092 — generally a praiseworthy act, if modestly so. So here we are, in a state of utter confusion.

### III. Harshness of the Results

#### A. Unintended Consequences

By Robert Gordon

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The straddle rules were intended to stop a perceived abuse whereby investors were entering offsetting positions only to lift a loss leg in one year, take the gain leg in a second year, and thus defer income from year to year. Unfortunately, these rules touched many more transactions than originally thought, especially after their expansion in 1984 and their inclusion of equities in 2004.

There are many unintended consequences to the rules that trap the unwary and penalize transactions that had no deferral motive. One of our businesses is hedging low-basis stock for individual investors. Many of these investors enter into a “zero-cost collar” to hedge the low-basis shares. A zero-cost collar consists of the purchase of a put option creating a floor — a minimum exit price to the investor. The collar also entails the sale of a call option limiting the client’s upside participation. The sale of the call options is designed to bring in enough money to pay for the put and thus becomes a zero-cost collar.

For example, an investor would buy a two-year put for \$12 and simultaneously sell a call for \$12. The purchase of the put creates a straddle that may cause an unjust tax result. Losses in one leg of a straddle cannot be taken until all legs of the straddle are disposed of, but any gains realized in managing the position are immediately taxable. Often the underlying equity that is part of the collar will not wind up outside the collar boundaries, and both options will expire worthless. However, the \$12 from the call sale is immediately taxable, while the \$12 loss from the put is deferred as an adjustment in the basis of the equity shares. The client is paying tax on \$12 of phantom income. If the client holds the shares until death, the step-up in basis will negate any capital gains tax and give the investor no value for a \$12 loss on the put. The law of unintended consequences is quite present in the straddle arena.

A second issue that has generated debate is whether the “married put” exception, available (if at all) under section 1233(c), still exists. This topic deserves an article of its own to flesh out all the possibilities. In a married put transaction, an investor simultaneously purchases an equity and a put option on that equity. According to section 1233, the position is allowed to age to long term even though the client holds a put. Normally, under

section 1233, the holding of a put suspends or terminates a client’s holding period. The question is whether the married put exception, which is still in the code, can still be relied on by taxpayers after the straddle rules’ expansion in 1984.

Do the straddle rules overrule the section 1233(c) exception? Option exchanges, newspapers, and investment services continue to promote the use of married puts, but the more technical practitioners we’ve queried doubt whether the election under section 1233(c) remains available. The ability for an investor to have an established floor but still enjoy the possibility of long-term gains is powerful, if it is indeed available. It would be most appropriate for those exercising incentive stock options (ISOs). Some ISO holders have found themselves holding for months trying to get to long-term treatment, only to see the value of their shares decrease, sometimes causing an alternative minimum tax larger than the value of the shares held. Investors need clarity in these areas when there are two different sets of rules that seem to counteract each other.

#### B. Frustration and the Straddle Rules

By David R. Nave

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One level of frustration in dealing with the straddle rules is encountered when a taxpayer enters into offsetting positions and disposes of the loss position and enough of the gain position to report realized gains equal to the realized losses. The tax consequences do not appear to be free of doubt.

**Example:** Taxpayer enters into an over-the-counter (OTC) collar designed to hedge her downside risk on a basket of low-basis securities. The collar has a put strike price of, say, 85 percent of the initial basket and a call strike price of 130 percent of the initial basket. The term of the collar is five years. Therefore, the collar should avoid the constructive sale rules.

Assume the value of the basket approaches the upper end of the collar and the taxpayer decides to close down the existing collar and enter into a new hedge using S&P 500 index options. To raise the funds necessary to close the collar, she sells ABC, which represents 30 percent of the basket. The gain on ABC equals the loss from closing the collar.

What are the tax consequences from the transactions? Because there is still unrecognized gain in the position, section 1092(a)(1)(A) would provide that losses would be deductible only to the extent that they exceed the unrecognized gain. This may result in little or none of the loss being used.

Another approach the taxpayer might use is to recognize losses in proportion to the property sold. In other words, because the gain property represented 30 percent of the basket, correspondingly, 30 percent of the loss would be recognized. While the statute does not provide for this approach, it would appear reasonable and should be respected by the Service.

*Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings*, ch. 387 (Practising Law Institute, 2008).

But the taxpayer has become very frustrated and questions why she can't simply net the realized gains against the realized losses. She would defer only losses that exceed the recognized gains, and in her case that would be zero. The taxpayer does not see how this is gaming the system. She is told there is no statutory support for the netting approach and that it might be viewed as aggressive. After this discussion, she is frustrated by the straddle rules.

#### IV. Straddle Concepts

##### A. Defining 'Position' Isn't Always Easy

By David Z. Nirenberg

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To have a straddle, a taxpayer must have two (or more) offsetting positions. This follows from section 1092(c)(1), which defines a straddle as "offsetting positions" in personal property, and from section 1092(c)(2)(A), which treats a taxpayer as having offsetting positions if there is a substantial diminution in the taxpayer's risk of loss from holding any position "by reason of his holding 1 or more *other* positions." (Emphasis added.) The requirement that a straddle comprise multiple positions permits an investment that consists of a single position to avoid characterization as a straddle even though the single position may have economic characteristics that closely resemble a combination of positions. Two examples illustrate the issue: (1) interests subject to a maximum payout, and (2) interests in partnerships in which one partner's interest is arguably, from another partner's perspective, economically equivalent to a position.

Consider a taxpayer that acquires a cash-settled call option on stock X at one strike price and simultaneously sells a European-style, cash-settled call option on the same stock with the same exercise date but at a higher strike price.<sup>17</sup> Presumably, the taxpayer would have a straddle because the acquired call option reduces the risk of loss on the written call option. There would be no straddle, however, if instead of writing a call option, the taxpayer acquires a cash-settled call option, the return on which is subject to a cap.<sup>18</sup>

Current law and IRS administrative guidance do not support treating a position that has an embedded cap as two separate positions, and, while there are some authorities to the contrary, the general rule is that a single indivisible security should be treated as a single position.

<sup>17</sup>A European-style option refers to an option that is exercisable only on its maturity date, as opposed to an American-style option, which is exercisable at any time before maturity.

<sup>18</sup>A call option that is subject to a cap is different in one significant respect from an acquired call option or written call option pair. With a single capped call option, unlike paired options, the taxpayer cannot dispose of the loss position while retaining the gain position for disposition in a later year. Thus, one significant abuse targeted by the straddle rules is not a concern with a capped option.

See *Chock Full O' Nuts v. United States*, concluding that a convertible debenture is an indivisible unit and should not be taxed as a bond/warrant investment unit representing two separate and independent obligations.<sup>19</sup> Although some authorities find a position embedded in a single, indivisible contract to be a position in a straddle, the conclusion generally is that the imbedded position forms a straddle *with respect to a separate position outside that contract* — not with respect to another position that is embedded in the contract.<sup>20</sup> The Service has recognized (at least tacitly) in some contexts that a cap on the return of a security is not a separate written call option.<sup>21</sup>

<sup>19</sup>453 F.2d 300 (2d Cir. 1971). See also LTR 9824026 (Mar. 12, 1998), *Doc 98-18694*, 98 *TNT* 114-22 (periodic and nonperiodic payments on a notional principal contract (NPC) give rise to ordinary income or loss and not capital gain or loss because an NPC is not treated as a series of forward contracts even though that would be the economic equivalent). Compare Rev. Rul. 2003-97, 2003-2 C.B. 80, *Doc 2003-17272*, 2003 *TNT* 142-20 (investment unit consisting of a five-year note and a three-year forward contract to purchase a quantity of the issuer's common stock treated as separate positions because, among other reasons, the holder has the unrestricted legal right to separate the note from the purchase contract/note unit and transfer the note separately and is not economically compelled to keep the unit undivided); Rev. Rul. 88-31, 1988-1 C.B. 302 (security that could be divided after an initial period into a share of stock and cash-settled put option is treated as two separate positions).

<sup>20</sup>See, e.g., FSA 200150012 (Sept. 11, 2001), *Doc 2001-30792*, 2001 *TNT* 242-28 (concluding that when the taxpayer owns shares of stock of an unrelated issuer and also issues a single instrument containing an imbedded written call option and an imbedded put option regarding that stock, each of the imbedded options is a straddle on the stock owned by the taxpayer because the stock reduces the taxpayer's risk of loss on the imbedded written call option and the imbedded put option reduces the risk of loss on the taxpayer's ownership of the stock); FSA 200131015 (May 2, 2001), *Doc 2001-20775*, 2001 *TNT* 151-15 (same); FSA 199940007 (June 15, 1999), *Doc 1999-32427*, 1999 *TNT* 196-50, modified by FSA 200130010 (Apr. 23, 2001), *Doc 2001-20230*, 2001 *TNT* 146-24 (concluding that when the taxpayer owns shares of stock of an unrelated issuer and also issues a single instrument containing an imbedded written call option and an imbedded put option regarding that stock, the imbedded put option is a straddle on the stock owned by the taxpayer because the imbedded put option reduces the risk of loss on the taxpayer's ownership of the stock); prop. reg. section 1.263(g)-4(c), Example 3; reg. section 1.1092(d)-1(d) (a debt instrument issued by the taxpayer the payments on which are tied to the value of personal property, such as stock of an unrelated corporation, is treated as a position in that personal property).

<sup>21</sup>See Rev. Rul. 88-31, 1988-1 C.B. 302 (an instrument that pays its holder an amount equal to \$11 minus the then-market price of a share of common stock, subject to a maximum of twice the stock's value, is classified as a put option). See also the field service advice discussed in note 18 (the IRS indicates that an instrument entitling its holder to a variable percentage of a common stock's market value (subject to an overall cap) might be analyzed as a combination of a written put and an acquired call (subject to a cap) without considering the possibility that the acquired call, on account of the cap, could itself be bifurcated into an acquired call and a written call at a higher strike price).

Another context in which a taxpayer may have a single position that economically resembles two offsetting positions is a partnership in which gains and losses are allocated disproportionately to capital. Consider, for example, a partnership that owns stock in a corporation and that has two classes of partnership interests, class A and class B. Class A is entitled to all the dividends paid on the stock and the proceeds of a sale of the stock up to a specified price, and class B is entitled to all proceeds of a sale above that specified price. Although the class B interest economically resembles a call option, it is clear that under general tax principles, the class B interest would be respected as a partnership interest and would not be recharacterized as a written option. See reg. section 301.7701-4(c)(2), Example 3, which treats a trust with similar classes of interests as a partnership.

Section 1092(d)(2) defines a position as “an interest (including a futures or forward contract or option) in personal property.”<sup>22</sup> Both positions need to be held by the taxpayer.<sup>23</sup> Although section 1092(d)(4)(C) treats a partner as holding a position held by the partnership, there is no authority treating a partner as owning positions of unrelated partners, and one partner’s interest in a partnership cannot rightfully be treated as an interest of the other partner. While each partner has an interest in the partnership, one partner cannot fairly be viewed as owning all of the partnership’s assets and as having written an option that reflects the interests of the other partners; the rights of the parties in a partnership differ from those of an option holder. In the case of a partnership, unlike the case of an actual option, no party has the right to possess the entire asset, and no party is taking the other’s credit risk. Disproportionate allocations of gains and losses are common in investment partnerships, and there appears to be no authority that would treat those allocations as creating a straddle for a partner solely within its partnership interest.

## B. Diminishing the Reach of the Straddle Rules

By Steven M. Rosenthal

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The straddle rules address a glitch in our realization-based income tax system. Unfortunately, the straddle rules also touch many common investment strategies, and their application in these circumstances is almost always unclear. The rules appear expansive, but in practice, they frequently are interpreted much more narrowly. This tension is due, perhaps, to an overoptimistic interpretation of the rules to avoid the unduly burdensome consequences of finding a straddle.

<sup>22</sup>In defining a position, reg. section 1.1092(b)-5T(h) unhelpfully cross-references section 1092(d)(2).

<sup>23</sup>This follows from section 1092(c)(2)(A), which describes offsetting positions as when a taxpayer’s risk of loss on one position is substantially reduced “by reason of his holding 1 or more other positions.” (Emphasis added.)

**1. Substantial diminution of risk.** Taxpayers often manage selected risks of their investment portfolios. For equities, taxpayers often manage the industry or general market risk from holding individual stocks. For bonds, taxpayers might manage the interest rate, currency rate, or credit risk from specific holdings. The key straddle question is whether any of these common strategies result in a substantial diminution of risk of loss from holding the investment positions. Common sense suggests that taxpayers must be managing a material amount of risk, but is the amount of the risk diminished substantial?

To answer this question, a practitioner must consider how much is substantial for purposes of the straddle rules. The term “substantial” in other parts of the tax law might mean one-third, one-half, or more than one-half. But how should a diminution of risk of loss be measured for purposes of the straddle rules? By a reduction in the potential amount of a loss, the likelihood of the loss, some combination of both, or some other test?

The legislative history to the original legislation explained only that mere diversification of assets usually does not substantially diminish a risk of loss.<sup>24</sup> But Treasury and the IRS have issued no regulations to help interpret the substantial diminution standard in the straddle rules, and they are not expected to do so.

**2. Analogy to the dividends received deduction.** By analogy, to receive a dividends received deduction, a taxpayer may not diminish its risk of loss of holding stock by holding one or more positions for substantially similar or related property, as provided in the regulations.<sup>25</sup> Under these regulations, property is substantially similar or related only if changes in the fair market value of the stock are reasonably expected to approximate changes in the FMV of the property or a fraction or multiple of that value.<sup>26</sup> The regulations also explain that stock in one corporation in the automobile industry is not reasonably expected to approximate changes in the FMV of stock in another corporation in the same industry, because the stock prices of the two corporations are affected both by the general level of growth in the industry and by the individual corporate management decisions and corporate capital structures.<sup>27</sup> So, by analogy, managing the risk of loss from industry-specific factors (or other specific factors) might not be substantial for purposes of the straddle rules, or so many appear to believe.<sup>28</sup>

<sup>24</sup>Joint Committee on Taxation, “General Explanation of the Economic Recovery Tax Act of 1981,” JCS-71-81 (Dec. 1981), at 288.

<sup>25</sup>Section 246(c)(4)(C).

<sup>26</sup>Reg. section 1.246-5(b)(1)(ii).

<sup>27</sup>Reg. section 1.246-5(d), Example 1.

<sup>28</sup>The special rules for straddles on stock explicitly use the “substantially similar or related property” standard. Section 1092(d)(3)(A). Also, the legislative history to the stock straddle rules contemplates that the definition of substantially similar or related property in the dividends received regulations will apply for straddle purposes. JCT, “General Explanation of Tax Legislation Enacted in the 108th Congress,” JCS-5-05 (May

(Footnote continued on next page.)

**3. Harsh consequences for investment strategies.** If a taxpayer determined that a straddle existed for the common investment strategies described earlier, the taxpayer would be subject to a number of consequences: (1) a suspension or termination of the holding period of stocks or bonds during the period an offsetting position was held, (2) the capitalization of carrying costs and interest costs of the straddle, and (3) the deferral of losses from positions in a straddle to the extent of any unrecognized gain at the end of the tax year in the offsetting positions to the loss position — “successor positions” and “offsetting positions to the successor positions.”<sup>29</sup> These consequences can be harsh both economically and administratively.

Finally, there are special reporting rules for taxpayers with straddle losses — although those rules are almost universally ignored. Under Part III of Form 6781, these taxpayers must list each position (whether or not part of a straddle) that is held at the end of the tax year if the value of the position exceeds its cost basis. This is a daunting task for any portfolio manager, so an optimistic reading of the rules appears to be the norm.

### C. Explaining Risk Reduction

By James N. Calvin

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For many years, I have tried to formulate a test for measuring risk reduction under the straddle rules. I am still not certain there will be one, and I doubt Treasury or the IRS will ever be motivated to provide one. As accountants preparing tax returns, explaining tax results to clients, and providing an initial response on audit, we are often faced with only a brief opportunity to explain why positions are or are not tax straddles. If that cannot be done clearly and quickly, either the audience or the initiative is lost.

As practical as I must be here, the more time I spend with this problem, the less practical I seem to get. I have, however, convinced myself that the covariance of the returns from the positions should be used to measure risk reduction and that a correlation coefficient of -0.65 is probably about right before there is a substantial diminution of risk. Other practitioners — and the Treasury regulations — take a more mechanical approach. The benefit of my approach is that it may have broader application within the straddle rules and sometimes even experienced investment professionals understand it. The downside is that it can become unwieldy in all but the simplest of situations.

In any event, any discussion should begin by explaining that the straddle rules were designed to eliminate taxpayers' ability to recognize artificial financial losses as tax losses. These losses were artificial because taxpayers would hold positions with offsetting, yet unrecognized,

financial gains. These offsetting gains could be deferred indefinitely by simply entering into offsetting transactions as contracts neared expiration.

The success of this tax strategy depended on prices moving in opposite or inverse directions. The more quickly prices and the values of the positions changed, the better. Leverage usually speeds up the process because it magnifies price changes. Thus, slightly different futures contracts were initially favored; however, any derivative positions would probably do, and holding or shorting the underlying position can work just as well if one does not mind waiting, or the positions can otherwise be leveraged.

If the strategy was well executed, the taxpayer was financially indifferent to the direction of price changes but could time the recognition of gains and losses for income tax purposes. The statute, however, does not define a tax straddle in terms of there being no risk; instead, there need only be a substantial diminution in a taxpayer's risk from holding offsetting positions.

**1. Risk in the straddle concept.** Section 1092(c)(1) defines a straddle as offsetting positions with respect to personal property. Section 1092(c)(2)(A) provides that a “taxpayer holds offsetting positions with respect to personal property if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).” The key components of this fundamental definition — substantial diminution and risk — remain undefined. The best that can be done is to infer the meanings of these terms from other, related sources.

As I have come to understand it, risk is generally taken to mean the dispersion of possible returns from a position. A wide range of possible returns is risky, while a narrow range is less risky. A frequently used measurement for determining whether there has been a diminution of risk in a two-position portfolio is the covariability, or covariance, of the returns from the positions. Covariance reflects the relatedness of the positions' returns. If returns move together, the covariance is positive; if the returns move in opposite directions, the covariance will be negative. The use of covariance to measure risk reduction for purposes of section 1092 appears appropriate because the straddle rules are directed at positions that move in opposite directions, that is, the values of the positions vary inversely.

**2. Substantial diminution of risk.** Harder to agree on, however, is the meaning of substantial diminution. It must be quantified to be of any practical use to our clients. There are, however, a couple of relevant sources that might suggest a meaning.

**3. Quantifying from the qualified call exception.** The first is the qualified covered call option (QCCO) exception. It seems reasonable that one could tease out the maximum risk reduction permitted under section 1092(c)(1) by testing calls meeting the QCCO exception against the underlying stocks when the QCCO exception was added to the code in 1984. In other words, the granting of a QCCO could not substantially reduce a taxpayer's risk of loss on the underlying stock, or Congress would not have included the exception. I realize

2005), *Doc 2005-11832*, 2005 TNT 104-17, at n.975. There is no comparable statutory language or legislative history for bonds.

<sup>29</sup>Section 1092(a) and reg. section 1.1092(b)-1T.

that the statute takes back what it seems to give by saying that a “straddle” consisting of one or more QCCOs and the optioned stock are not treated as a straddle. However, if there really was too much risk reduction, the QCCO exception would not have been added to the statute. Thus, one could presume that the risk reduction in a QCCO was acceptable to Congress despite the statutory language.

While a QCCO may not be a perfect proxy for other opposing positions, the risk-reducing quality of a QCCO can be determined and imported to other portfolios containing positions whose values may vary inversely. Because the degree of risk reduction in a QCCO can be presumed acceptable, it might serve as a benchmark in determining whether other positions are offsetting and therefore whether those positions are subject to the straddle rules. A preliminary observation made in 1994, using prices that existed when the QCCO exception was added to the code, indicated that a portfolio consisting of a QCCO and the optioned stock resulted in a correlation coefficient of approximately 0.65. Thus, one might argue that positions that are negatively correlated to at least that degree still would not constitute a tax straddle.

**4. Substantially similar or related property.** Another source implying a similar level of acceptable risk reduction is the regulations issued under section 246(c)(4)(C). Those regulations define the term “substantially similar or related property” for purposes of reducing the holding period for the dividends received deduction. That term is also referred to by section 1092(d)(3)(i) for purposes of the stock straddle rules.

Among the definitions and rules provided in the section 246(c)(4)(C) regulations is the substantial overlap rule. Under that rule, a position that reflects the value of a portfolio is not treated as substantially similar or related to the taxpayer’s stock holdings unless the stock holdings and the portfolio substantially overlap. A taxpayer’s stock holdings substantially overlap with a portfolio if the taxpayer holds 70 percent, by value, of the stocks in the portfolio — that is, the taxpayer holds 70 percent of the capitalization of the portfolio.

The regulations provide an antiabuse rule that treats a position and a portfolio as substantially overlapping even if mechanically there is no substantial overlap. Generally, to fail this antiabuse rule, there must be a reasonable expectation that the two sides will virtually track (directly or inversely) and the positions must be acquired as part of a plan. Despite the antiabuse rule, the approach taken in the regulations is quite mechanical and does not require any special math to conclude that something less than 70 percent is not substantial.

**5. Conclusion.** While there is no explicit definition of substantial for purposes of determining whether a straddle exists, it seems that a negative correlation of something less than 0.70 is not substantial for that purpose. The QCCO exception is consistent and can support something in the range of -0.65. The risk this implies is apparently substantial from a practical perspective as well. In the ultimate test, I have found that investment professionals frequently recoil when informed of the level of risk that may be required to avoid a tax straddle.

## D. Unbalanced Positions in Straddles

By Mark Fichtenbaum

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The straddle rules were first enacted in 1981 and were meant to act as an antiabuse section. Unlike the short sale and wash sale rules, which deal with substantially identical property, the straddle rules apply when there is a substantial diminution of risk from holding any position in personal property by reason of holding one or more other positions with respect to personal property. Determining the components of a straddle may be problematic because of this expansive definition.

Determining whether a substantial diminution of risk has occurred can often be difficult. One of the most basic problems arises when it is clear that the investor has decreased its risk of loss from holding personal property, but the amount of property held and the risk-reducing transaction cover different amounts. For example, assume an investor owns 60,000 ounces of gold and enters into a forward sale of 50,000 ounces. The forward sale eliminates the risk of loss on 50,000 ounces of gold and leaves the investor at risk on the remaining 10,000 ounces. However, another way to look at the transaction is that, before entering into the forward sale agreement, the taxpayer was at risk on the price movement in gold for 60,000 ounces, and while the forward contract remains open, the risk has been reduced to the price movement on only 10,000 ounces. The more rational answer should be that the straddle exists only with respect to 50,000 ounces. If the investor just sold 50,000 ounces of gold, the other 10,000 ounces would not be affected from a tax viewpoint. The immediate sale is a better risk-reducing transaction than the forward sale, because all credit risk has also been removed. It would be a strange result if the forward sale tainted more shares than the immediate sale of gold. However, I have been at seminars where a Treasury official has stated that the entire 60,000 ounce position may be tainted by the straddle rules.

An investor may try to use self-help to ensure that only 50,000 ounces are tainted by the straddle rules by identifying the straddle as consisting of the forward sale and 50,000 ounces of gold under section 1092(a)(2)(B). However, an identified straddle may not be part of a larger straddle, so the identification may not hold up.

Another difficulty in determining the size of a straddle is when the offsetting position is greater than the amount of the physical position held. Again, assume the investor holds 60,000 ounces of gold and sells at-the-money calls on 100,000 ounces of gold. The investor was told that to hedge gold with at-the-money options, it should sell twice as many options as the physical quantity of gold held. Again, the investor only wanted to hedge against the price movements in 50,000 ounces of gold. Assuming that the relationship between the quantity of gold held and the amount of options to sell is correct, the same basic problem presented in the previous example exists here. If the investor uses dynamic hedging by constantly

selling or buying more options as the price of gold fluctuates, the problem of identifying the straddle is only compounded.

The use of an election under section 1092(a)(2)(b) would be helpful to the investor in such a circumstance to group together the hedging transactions with the 50,000 ounces of gold.

The question of the size of the straddle also arises in determining whether a call is a qualified covered call under section 1092(c)(4). Stock and a qualified covered call are not subject to the straddle rules. However, all of the offsetting positions making up any straddle consist of one or more qualified covered call options and the stock to be purchased from the taxpayer under those options, and that straddle is not part of a larger straddle.

To be a qualified covered call, the requirements of section 1092(c)(4)(B) must be satisfied. The requirements primarily deal with the strike price of the call and its time until expiration. Rev. Rul. 2002-66<sup>30</sup> states that owning stock, writing calls on the stock, and purchasing puts on the stock would all be treated as part of one straddle. In that case, the calls would not be treated as qualified covered calls.

However, a problem similar to that shown in the second gold example occurs if the investor owns 50,000 shares of a stock and sells calls on 100,000 shares of the stock. Section 1092(c)(4)(A) says that the straddle must consist only of the calls and the stock to be purchased from the taxpayer under those calls. If the straddle consists only of the stock and the options covering 50,000 shares, the calls and stock should be exempt from the straddle rules. However, if the straddle consists of all the calls and the stock, it would appear that the qualified covered call exception to the straddle rules would not be satisfied.

The straddle rules have existed for almost 30 years, and the basic question of what constitutes a straddle remains unanswered. Hopefully there will be some guidance about what constitutes a straddle in situations when the two or more legs of the straddle cover differing amounts of the underlying property.

### E. What Is Part of a Larger Straddle?

By John Ensminger

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Given the significance of whether a position is part of a larger straddle, it might be expected that the concept would have been the subject of regulatory attention. But, like with many aspects of the straddle rules, there is little guidance here. Probably the most helpful statement for determining when a straddle is part of a larger straddle is found in LTR 199925044,<sup>31</sup> which involved a costless collar of "corporation stock" in which the taxpayer purchased a cash-settlement put option from a counterparty and sold a cash-settlement call option to that

counterparty, both having the same trade and maturity dates. The number of shares of corporation stock owned by the taxpayer exceeded the total number of shares used as collateral and the number of shares specified in the costless collar. The IRS said the put option and the corporation stock constituted a straddle, as did the call option and the corporation stock. The taxpayer was permitted to identify 100 puts and 100 shares as a straddle, and 100 calls and the same 100 shares as a straddle, and neither was part of a larger straddle with the stock used as collateral for the loan or the remaining stock. There was no discussion of a delta issue,<sup>32</sup> and the IRS emphasized that it saw no opportunity for abuse.

In TAM 200033004,<sup>33</sup> the IRS determined that the existence of a larger straddle is tested on a stock-by-stock basis, rather than for a portfolio in the aggregate, noting that the conference report to the Tax Reform Act of 1984 said that the "substantially similar" standard is not satisfied merely because an investor with diversified holdings acquires a regulated futures contract or an option on a stock index ("a single instrument") to hedge general market risks. Under reg. section 1.246-5(c)(1)(v), however, a position that reflects the FMV of more than one stock but not of a portfolio (20 or more unrelated issuers) is treated as a separate position as to each of the stocks whose value the position reflects.

In Rev. Rul. 2002-66, the IRS considered what happens when the grantor of a qualified covered call option holds a put option on the same underlying equity. In three situations described in the ruling, the presence of the purchased put caused the stock and the qualified covered call to constitute part of a larger straddle under section 1092(c)(4)(A). In the third situation, the taxpayer purchases stock and two days later writes a call option on the stock. Two months later the taxpayer purchases a put on the stock, at which point the first two positions become part of a larger straddle. Rev. Rul. 2002-66 demonstrates that in defining "part of a larger straddle," guidance on the timing issues will be necessary.

If there is no opportunity for abuse, it would appear that an identification should not be undone, and further identification of the new position with the positions inside the identified straddle should not be required despite the arguable "larger straddle" status. By the identification of the straddle, the taxpayer has moved from a deferral regime to a capitalization regime, and the accounting change should be respected.<sup>34</sup> However, if the situation appears to be part of a strategy, what antiabuse provisions should the IRS apply? Treasury should be

<sup>32</sup>The possibility of taking delta into account has been considered in comments and reported in appearances of Treasury officials. See New York State Bar Association, "JOBS Act Straddle Amendments," letter of David Hariton to Treasury officials (Nov. 11, 2005), *Doc 2005-23137*, 2005 *TNT* 219-22. Taking delta into account would mean that a straddle could be unbalanced by calculations other than a simple pairing of instruments but would require recalculation on a recognition event.

<sup>33</sup>*Doc 2000-21554*, 2000 *TNT* 162-21.

<sup>34</sup>The third situation described in Rev. Rul. 2002-66 does not involve changing the type of straddle accounting. The qualified  
(Footnote continued on next page.)

<sup>30</sup>2002-2 C.B. 812, *Doc 2002-22392*, 2002 *TNT* 192-7.

<sup>31</sup>*Doc 1999-22044*, 1999 *TNT* 123-57.

answering these questions in comprehensive regulations. I despair of that happening, but also despair of Congress issuing more and more precise legislation to make up for the lack of regulatory effort.

## V. Foreign Currency

### A. 1256 and Currency Contracts: It's a Mess Inside

By *Viva Hammer*

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The decree of mark-to-market was imposed on futures contracts as an alternative to the balanced position rule, which was Congress's primary weapon against the straddle shelters. The industry was outraged at the idea. To forestall mutiny, Congress offered exchange-traded contracts governed by market-to-market a character advantage so attractive that immediately after enactment of the legislation, some non-exchange-traded contracts clamored to come under the law as well. Observers present when mark-to-market was expanded claim that Congress intended the expansion to cover only foreign currency (FX) forwards. But modern readers of section 1256(g)(2) find no indication that one type of FX derivative should be treated differently from any other — whether it be a forward, option, or swap. And so out of the debates between tax archeologists and strict constructionists is born the beautiful mess of the taxation of FX derivatives.

The idea of requiring mark-to-market was introduced in the straddle hearings of 1981. John Chapoton of Treasury said that the balanced (offsetting) position rule could not apply for taxpayers with a significant volume of commodities transactions because it required "the identification of particular positions [and would be] cumbersome to apply."<sup>35</sup> Treasury proposed instead that these persons be subject to a mandatory mark-to-market rule for their positions in futures contracts traded on an organized futures exchange. Because futures positions are marked to market daily under the normal operating rules of the exchange with actual cash settlements, this rule would make the tax laws reflective of the underlying market transactions.<sup>36</sup> Treasury proposed to tax the mark-to-market gains and losses as ordinary.

Taxpayers targeted by the new rule were predictably offended. Donald Schapiro, representing the New York State Bar Association (NYSBA) Tax Section, knew Congress would have to offer some enticement to lure taxpayers into the new regime. He and the NYSBA advocated long-term capital character for the mark. The

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covered call, when created, is excepted from straddle treatment. Only after the put is purchased does the taxpayer move into straddle accounting.

<sup>35</sup>Commodity Tax Straddles: House Ways and Means Committee hearing, 97th Cong. 71 (1981) (statement of John E. Chapoton, Treasury assistant secretary for tax policy).

<sup>36</sup>*Id.* at 63.

argument was that because gains and losses were a zero sum in the futures markets, Treasury should be indifferent to character. It was expected that taxpayers, in contrast, would consider capital character so attractive that they would cooperate with mark-to-market.

A certain Michael L. Maduff of Chicago protested vociferously against mark-to-market in testimony before the Senate Finance Committee, calling it a "very bad scheme" and a "radical departure from our system of taxation."<sup>37</sup> However, he confessed, "If . . . Congress were to pass a bill which incorporated [mark-to-market] at a very favorable tax rate, I would be delighted to conduct my business under such a bill, under such a law."<sup>38</sup>

And so it transpired that mark-to-market came into being, with the enticement of a 60 percent long-term and 40 percent short-term capital gains and loss rates, in section 1256. In an era when there was a possible 42 percent rate differential between ordinary income and long-term capital gains, that was sweet indeed.

Congress knew mark-to-market was a radical departure from the U.S. tax system. To survive, the new law would have to be framed in a way to avoid challenge under the Constitution. *Eisner v. Macomber*<sup>39</sup> was heavily diluted by 1981 but had never been overruled. The realization principle was still part of tax jurisprudence, and mark-to-market had to be dressed up to fall within the ambit of that principle.

A futures exchange needs a high level of trust to operate effectively, because every contract is guaranteed by all those permitted to transact there. The exchange uses a deposit and margining system to ensure performance under a futures contract. Every time a contract is entered into, a deposit is placed with the exchange, and every movement in value of the contract involves either the depositing of further money (if contract value declines) or the ability to withdraw money (if contract value increases). This mechanism was seized on by advocates of mark-to-market as an opportunity to tax parties to the contracts consistent with the flows of cash and with the way exchanges conducted business.

Opponents claimed that mandatory mark-to-market for futures contracts gave off-exchange contracts an unfair advantage.<sup>40</sup> Schapiro, representing the NYSBA, thought this was the correct result because "executory contracts . . . don't involve daily transfers of cash. They are not a sum zero system."<sup>41</sup>

Congress need not have worried about an immediate constitutional challenge (although it did come later). Sixty-four was such a winning formula that as soon as

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<sup>37</sup>*Id.* at 202 (statement of Michael L. Maduff, Maduff & Sons Inc.).

<sup>38</sup>*Id.*

<sup>39</sup>252 U.S. 189 (1920).

<sup>40</sup>Commodity Tax Straddles: Hearing before the Taxation and Debt Management and the Energy and Agriculture Taxation subcommittees of the Senate Finance Committee, 97th Cong. 90 (1981) (statement of Lee H. Berendt, president, Commodity Exchange Inc.).

<sup>41</sup>*Id.* at 111-112 (statement of Donald Schapiro, NYSBA Tax Section).

mark-to-market was enacted for futures contracts, representatives of the banking industry implored policymakers to include their contracts also.<sup>42</sup> Acting with uncharacteristic alacrity, in 1982 Congress enacted mark-to-market for “foreign currency contracts.” The legislative history recognizes that there is no equivalent to the margining mechanism in the over-the-counter market, but Congress was no longer concerned with the realization principle. It sought to tax FX contracts off exchanges equivalently to those on exchanges.<sup>43</sup> Congress delineated the extension of mark-to-market in crisp language:

Section 1256(g)(2) FOREIGN CURRENCY CONTRACT DEFINED. — The term “foreign currency contract” means a contract —

(A)(i) which requires the delivery of, or the settlement of which depends on the value of, a foreign currency which is a currency in which positions are also traded through regulated futures contracts,

(A)(ii) which is traded on the inter-bank market, and

(A)(iii) which is entered into at arm’s length at a price determined by reference to the price in the inter-bank market.

Although the law refers to FX contracts, the legislative history talks about “bank forward contracts” only. No good explanation has been given for the discrepancy between the language in the law and in the history. Practitioners who were present when the law was being delivered insist that the term “foreign currency contracts” was intended to include only FX forwards. They offer as proof the requirement that the contracts be traded on, and priced by reference to, the interbank market. Those who read the code as a free-standing document find no such intent to limit the term to FX forwards. The term “foreign currency contracts” could conceivably include forwards, options, and swaps. All these can be traded and priced by reference to the interbank market.

The IRS has given taxpayers little help in solving the conundrum, although it has been asked to do so several times. The question in LTR 8818010<sup>44</sup> was whether FX swaps were FX contracts under section 1256(g)(2). The ruling states that “Congress intended to include within the definition of foreign currency contract bank forward contracts in currencies traded through regulated futures contracts because they are economically comparable and used interchangeably with regulated futures contracts.” The ruling concludes that because “currency swap contracts typically account for interest rate differentials through a present and continuing exchange of notional interest payments over the life of the contracts while bank forward contracts account for such difference upon maturity,” and because there is no intention in the

legislative history to include swaps under section 1256(g)(2), swaps do not come within that code section. The ruling does not attempt to interpret the plain language of the statute.

FSA 200025020<sup>45</sup> addressed OTC currency options. While acknowledging that FX options could fit the section 1256(g)(2) definition, the field service advice states that the options should not be governed by that section. The reasons given are: (1) FX options are not specifically mentioned in the legislative history and so must not have been meant to be included; and (2) including FX options under section 1256(g)(2) overrides the limitations of those parts of section 1256 dealing with exchange traded options.

LTR 8818010 and FSA 200025020 have acquired statutory status for practitioners. Thus, the IRS put the cat among the pigeons in publishing Notice 2003-81,<sup>46</sup> which has a higher status than either the letter ruling or the field service advice and is contrary in its conclusion. The subject of the notice was a tax shelter that used OTC currency options. In describing the shelter, the notice says regarding the OTC options: “The currency [which is the subject of one set of options in the shelter] is one in which positions are traded through regulated futures contracts, and the purchased options, therefore, are foreign currency contracts within the meaning of section 1256(g)(2)(A) of the Internal Revenue Code and section 1256 contracts within the meaning of section 1256(b).”

Once the IRS published substantial authority-level guidance requiring mark-to-market treatment for OTC currency, taxpayers became anxious about the conclusions in the old letter ruling and field service advice. What were they to do about swaps and other FX derivatives?

The anxiety continued until 2007, when the IRS issued a notice contradicting the 2003 notice. Notice 2007-71<sup>47</sup> states: “Although as a general matter the ‘Facts’ portion of Notice 2003-81 correctly describes the transaction at issue, it includes an erroneous conclusion of law.” After quoting the sentence regarding the treatment of FX options excerpted above, the notice says, “This sentence should have stated ‘*The taxpayer takes the position that the purchased contracts are foreign currency contracts within the meaning of section 1256(g)(2)(A).*’” (Emphasis added.)

The 2007 notice refers to the legislative history of sections 1256 and 988 and concludes that an FX option is not an FX contract under section 1256(g)(2).

What are taxpayers left with? The character advantage, which allowed mark-to-market to pass through the eye of the needle in 1981, has undergone several significant changes since the enactment of section 1256. FX transactions are governed by section 988 and generally get ordinary treatment. The rate differential between ordinary income and capital gain has shrunk and then widened again.

<sup>42</sup>See letter from Frank V. Battle Jr. to Thomas Gallagher, Department of the Treasury (Dec. 8, 1981); letter from Donald C. Lubick to Robert Woodward, Department of the Treasury (July 12, 1982).

<sup>43</sup>S. Rep. No. 97-592 at 4172.

<sup>44</sup>Feb. 4, 1988.

<sup>45</sup>Doc 2000-17350, 2000 TNT 123-74.

<sup>46</sup>2003-2 C.B. 1223, Doc 2003-25811, 2003 TNT 234-4.

<sup>47</sup>2007-2 C.B. 472, Doc 2007-18700, 2007 TNT 156-2.

During the same period, mark-to-market taxation lost its reputation as being “a very bad scheme” and became increasingly accepted as the correct method to tax financial contracts.<sup>48</sup>

But the taxation of FX options, swaps, and similar contracts remains uncertain. Should these contracts be marked to market under the plain language of the statute, or should they be taxed under the realization principle? How do the character rules of sections 988 and 1256 interact for these contracts? And how can any policymaker justify a differing treatment of FX forwards from other OTC currency derivatives based on the history of a statute when the statute itself is so clear?

I counsel those whose slumber is disturbed by such uncertainty that they should not worry: With uncertainty there is always opportunity.

## B. Exempting Foreign Currency Losses

By Matthew A. Stevens

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One of the main difficulties with the straddle rules is that they contain no exemption for losses that are incurred in transactions that are not tax motivated. This is especially problematic in the case of foreign currency because many U.S. multinationals face foreign currency exposures as part of their business operations. Attempts to hedge these exposures may result in straddles.

Consider a U.S. multinational corporation that sustains a loss in an actively traded nonfunctional currency, such as the euro. The corporation would be unable to take that loss into account for tax purposes if it, any member of its affiliated group, or any passthrough entity in which it held an interest held any other position in the euro that had been offsetting to the loss position when the loss position was closed. To be sure, those currency losses will often be subject to the hedge timing rules rather than the straddle rules. However, the hedge timing rules will not always come to the taxpayer's rescue (for example, when a taxpayer hedges the currency risk arising from changes in the value of a capital asset).

Given the administrative burden on both the taxpayer and the government to comply with the terms of the straddle rules, it would be desirable if the statute contained an exception for FX losses arising from straddle transactions that were not tax motivated.

**1. Possible carveout for foreign currency losses.** However, I do not advise adopting a principal purpose test, as these are difficult to administer. More specifically, it is fairly easy to determine whether a taxpayer has entered into a transaction with *the* principal purpose of avoiding taxes, but much harder to determine whether the tax-

payer had *a* principal purpose of avoiding taxes. (The former is, in the government's eyes, too weak to deter abuse.)

Instead I recommend a carveout from the straddle rules for foreign currency losses arising from transactions that would be hedging transactions described in section 1221(a)(7) and the regulations thereunder if those regulations applied to currency fluctuations for a capital asset used in a nonfinancial business, not just ordinary property. For example, a taxpayer that lends funds denominated in a foreign currency to a foreign partnership in which it is a partner may wish to hedge its exposure to that foreign currency by hedging. That the asset must be used in a nonfinancial business makes it difficult for taxpayers to have the financial freedom necessary to enter into tax-efficient straddles. Thus, the government need not be concerned that this exception will permit widespread tax avoidance. Moreover, the IRS and Treasury appear to have the power to adopt this change by regulation if they wish.<sup>49</sup>

Alternatively, the government may believe that under current law, if a taxpayer hedges currency risk on a debt or equity instrument that is a capital asset, the transaction constitutes a hedging transaction under reg. section 1.1221-2(b). If that is the case, clarification of this point in the form of a ruling would be welcome.

There are several easily implemented and fair solutions that should be acceptable to the government and to taxpayers regarding foreign currency losses arising from straddle transactions that were not tax motivated. As with many straddle issues, Treasury holds enough cards to provide appropriate relief.

## VI. Accounting

### A. Identified and Unidentified Straddles

By Mark H. Leeds

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The premise behind the application of the straddle rules is straightforward: Investors in exchange-traded financial instruments should not be allowed to currently recognize losses to the extent that they hold offsetting positions with built-in unrecognized gains. As the straddle rules have been amended over the years, however, Congress has not been consistent in their application. The inconsistency can result in anomalous consequences.

**1. Basic straddle accounting.** The basic straddle rule creates a notional account. The taxpayer who has lifted a loss leg of a straddle must credit this account with the excess of the recognized loss over the unrecognized

<sup>48</sup>The literature calling for this is vast. The voice of one eminent advocate can be found here: Daniel Halperin, “Saving the Income Tax: An Agenda for Research,” *Tax Notes*, Nov. 24, 1997, p. 967, *Doc 97-31881*, or *97 TNT 226-55*.

<sup>49</sup>See reg. section 1.1221-2(b)(3) (extending the definition of hedging transaction “to manage such other risks [*i.e.*, besides risks with respect to ordinary assets or borrowings] as the Secretary may prescribe in regulations”).

gain.<sup>50</sup> At the end of each subsequent year, the taxpayer compares the balance in the notional account against the unrecognized gain in the offsetting position. If the unrecognized gain has decreased, the notional account is debited and that amount may be claimed as a current loss.<sup>51</sup> For example, assume that a taxpayer recognized a \$1,000x loss on the closing of the loss leg of a straddle. Assume further that the unrecognized gain in the offsetting position is \$1,200x. The taxpayer would not be entitled to claim any current loss and would credit the notional account with \$1,000x. If at the end of the succeeding year the unrecognized gain in the offsetting position fell to \$800x, the taxpayer would be entitled to claim a loss of \$200x.

**2. Identified straddle accounting.** In contrast to the general straddle rules, the identified straddle rules adopt a capitalization regime. The identified straddle rules create a safe harbor that allows a taxpayer to ring-fence two positions for purposes of the straddle rules. The code specifies three requirements for a straddle to be treated as an identified straddle: (1) it must be identified as such on the day that it is entered into, (2) the value of each straddle leg must not be less than the basis of each straddle leg, and (3) the positions must not be part of a larger straddle. On its face, the identified straddle election is very favorable because it allows a taxpayer to reduce risk on less than its full position without suffering straddle consequences over the entire holding. For example, assume that a taxpayer holds 1,000x shares of XYZ shares, enters into a transaction that constitutes a straddle on 500x XYZ shares, and makes an identified straddle election. In that case, the straddle consequences will be determined for the 500x XYZ shares that are identified as part of the straddle and not the entire 1,000x XYZ share position.

The code could certainly have created a notional account for any recognized loss on the identified straddle and allowed the taxpayer to recognize the loss to the extent that it did not exceed the gain on the position that had been part of the identified straddle. Instead the code takes another tack. For identified straddles, it requires that any recognized loss on an identified straddle increase the basis of each offsetting position (in the same ratio that unrecognized gain bears to all gain in the offsetting positions). A technical issue arose when the offsetting gain position was a liability (such as a short sale) and not a position to which basis attached. This was corrected by section 1092(a)(2)(A)(iii), which specifies that if there is no property to which the increase in basis can attach, the basis increase will be applied in a manner that is consistent with the basic rule. In the short sale example, the cost of the shares ultimately acquired to close the short sale would be increased by the unrecognized loss.

**3. Death and straddles.** If the taxpayer dies after lifting the loss leg of an unidentified straddle transaction but before recognizing all gain in the offsetting position, the unrecognized loss should constitute a deduction in re-

spect of a decedent.<sup>52</sup> As a result, when the estate receives a basis step-up in the offsetting position or otherwise recognizes the gain in the offsetting position, the estate of the decedent should recognize an income tax benefit (a loss deduction) in respect of the loss that had been deferred under the straddle rules. In contrast, for identified straddles the unrecognized loss is capitalized, that is, added to basis. Accordingly, on death, when the basis of the offsetting position is reset to market,<sup>53</sup> the advantage of the prior basis increase is lost and no tax benefit will be allowed for the previously unrecognized loss.

**4. No policy basis for different treatments.** There appears to be no policy basis for this different treatment or for the different treatment of recognized losses on identified straddles versus unidentified straddles in general. One could argue as a matter of tax policy that the identified straddle result is more consistent with the fresh-start approach of section 1014 because the gain on the offsetting position is eliminated tax free. However, (1) the loss was an economic loss recognized by the decedent, and the basis step-up inures to the benefit of the transferee, and (2) the estate tax acts as a surrogate for the lost income tax. On balance, the historic approach taken for unidentified straddles does not actually provide an unwarranted tax benefit.

## B. Rational Limits of Offsetting Positions

By Stevie D. Conlon

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The potential expense and mechanical operation of the section 1092 straddle tax deferral rules are overwhelming. As with many anti-abuse-motivated tax rules, the net cast by the straddle rules seems much broader than the original tax-motivated transactions that triggered their enactment. And tracking the straddles, related positions, loss deferrals, holding period adjustments, and interactions with the related wash sale rules for most investment accounts and taxpayers is beyond the current capabilities of many tax accounting systems. I consider straddles space a multidimensional universe of significant complexity. Constructive sales-related transactions governed by section 1259 occupy an overlapping but distinctly different parallel space of comparable difficulty.

I spent most of 2007 leading the development of an automated tax straddle tracking and adjustment computer system for investment portfolios that is now used by a number of money managers. A core task was developing an automated method to identify and track straddles, particularly because the task was manually burdensome.

Section 1092(c)(1) defines a straddle as "offsetting positions with respect to personal property." Section 1092(c)(2)(A) generally defines offsetting positions as

<sup>50</sup>Section 1092(a)(1)(A).

<sup>51</sup>Section 1092(a)(1)(B).

<sup>52</sup>Section 691(b); reg. section 1.691(b)-1.

<sup>53</sup>Section 1014(a).

arising “if there is a substantial diminution of the taxpayer’s risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).” Section 1092(c)(2)(B) provides a narrowing rule in the case of identified straddles that permits a taxpayer to ignore whether other positions that are not identified with the straddle constitute offsetting positions to positions of the identified straddle.

**1. One-to-one and one-to-many.** The substantial diminution of risk standard is broad enough that it requires the diligent taxpayer to look hard at his portfolio activity. For analytical purposes, let’s start with two broad generalizations. Some positions have a one-to-one risk relationship with each other. For example, assume a taxpayer owns Acme stock and then shorts the same quantity of Acme. If the value of the stock goes down, the value of the short position should go up a corresponding amount. The quantity of the long and short positions is the same. As opposed to one-to-one, some positions have a one-to-many or disproportionate risk relationship with each other. In this case, a taxpayer may own 100 shares of Acme stock and enter into a short position with 400 shares of Beta stock in which the value of the short position tracks the changes in value of the Acme stock holding even though the quantities of the long and the short are different. Assessing whether the substantial diminution of risk standard has been met in disproportionate one-to-many relationships can be difficult. Developing methods to identify and track those offsetting positions can be complex.

The phrase “one-to-many” could have other meanings. For example, it could be used to mean that the risk associated with one position could be offset by several different positions. There are several issues associated with one-to-many relationships of this type. One of them — possible simultaneous multiple straddles — is discussed below with the bond A and bond B example.

**2. Sizing straddles and unbalanced positions.** Another quandary with the definition of a straddle relates to positions that are unbalanced in size. For example, assume that a taxpayer owns 500 shares of Acme stock and shorts 300 shares. Is there one straddle composed of a 300-share long position and the 300-share short? Is there a straddle composed of the entire 500-share long position and the 300-share short? It could be argued that the 300-share short substantially diminishes the risk of loss for the entire 500-share long position. It could also be argued that it is unclear which of the 500 long shares are part of the straddle and which are not; treating all of them as part of the straddle could be viewed as simpler. Of course, the more difficult threshold question is whether unbalanced positions satisfy the substantial diminution standard.

**3. Establishing straddles on a single day or over time.** Issues can also arise when positions are acquired over time. For example, assume a taxpayer owns 1,000 shares of Acme and then enters into a 300-share Acme short. Assume that one month later the taxpayer shorts 200 more shares of Acme. Is there one straddle consisting of 500 shares of Acme and the two short sales? Or are there two separate straddles? Note that one complication with

treating the positions as part of a single straddle involves the determination of the holding periods of the positions.

Congress addressed some concerns regarding balanced and unbalanced straddles in the American Jobs Creation Act of 2004.<sup>54</sup> However, the fundamental questions remain.

**4. Multiple straddles with the same positions.** One possible problem under the straddle rules arises when a single position is potentially an offsetting position to more than one position, thereby creating multiple straddles from the same positions. For example, assume that a taxpayer owns two \$100,000 bonds (bond A and bond B) and short-sells a \$100,000 Treasury bond. Assume that the short position offsets the risk of loss for either bond. Also assume that we are focusing on one-to-one relationships. Is there one straddle — the short linked to one of the bonds? Or are there two simultaneous straddles involving the same short (linked to bond A and then linked again to bond B)?

In a way, tracking two simultaneous straddles involving the same positions over time could create complex decision trees of potential straddle deferrals and holding period adjustments. Just tracking simultaneous straddles could be a challenge.

Making an identified straddle election generally eliminates this concern because of the section 1092(c)(2)(B) limitation on the definition of offsetting positions referenced earlier.

**5. Rational limits.** Rather than simply freezing in place because the lack of a clear definition and guidance creates too many potential straddles, there may be a more measured and rational approach. As a general matter, a taxpayer that enters into both short and long positions is probably taking into account the potentially offsetting nature of the positions in his investment strategy. And the taxpayer may have common practices regarding which positions are used to offset others. It seems logical that such strategy and practices could be used to establish normal rules for establishing a straddle and linking the positions. Those rules could then be used by the taxpayer to track straddle deferrals and holding period adjustments. Hopefully, someday in the future when the IRS or the courts provide clarification, they will adopt definitions that are workable.

### C. Gain or Loss on Termination

By Linda E. Carlisle

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Before 1981, commodity transactions were used to create “silver butterflies,” “gold cash-and-carry transactions,” and “T-bill rolls” to defer and convert ordinary income into capital gains. In June 1980, however, the

<sup>54</sup>For a discussion, see Stevie D. Conlon, “2004 Tax Act Straddle Rule Changes — The Balancing Act: New Rules for Identified Straddles and Other Changes,” 18 *J. Tax’n & Reg. Fin. Inst.* 6 (July/Aug. 2005).

process of tax reform in the commodity area began, and the butterflies began to take flight.

The Economic Recovery Tax Act of 1981 (ERTA) enacted a set of new rules to reform the world of financial transactions, which at that time consisted mainly of commodity derivative transactions. ERTA dealt comprehensively with commodity transactions by imposing the recognition of losses on straddle positions under section 1092, requiring regulated futures contracts to be marked to market under section 1256, requiring the capitalization of interest and carrying charges for straddle positions under section 263(g), and settling the “confusion” that had arisen regarding the treatment of some contract rights under section 1234A. Rather than undergoing reform, however, section 1234A has increased uncertainty and muddied the treatment of some contract rights.

The original version of section 1234A provided that gain or loss from the termination of rights or obligations with respect to actively traded personal property that is, or on acquisition would be, a capital asset in the hands of the taxpayer was treated as a capital gain or loss. Thus, it would apply to assets that would qualify as positions in a straddle. The legislative history provided that ordinary loss treatment from the termination of such a contract is inappropriate because the settlement of a contract to deliver a capital asset is economically equivalent to the sale or exchange of the capital asset.

Section 1234A was amended in 1982 to add section 1234A(2), which provides capital gain and loss treatment for the termination of a section 1256 contract if that contract is a capital asset in the hands of the taxpayer. Congress was concerned that those contracts, which settle only in cash, would not be treated as rights or obligations regarding capital assets because cash is not a capital asset. The legislative history makes it clear that capital gain or loss treatment under section 1234A(1) was based on the termination of contracts with respect to *property* that is, or on acquisition would be, a capital asset in the hands of the taxpayer.

In 1997 Congress amended section 1234A to expand its application by deleting the “actively traded personal property” restriction (thereby eliminating a cross-reference to section 1092). Thus, section 1234A applies to

the termination of rights or obligations with respect to any property, not just publicly traded property.

Proposed regulations addressing the character of income deductions, gains and losses from notional principal contracts (NPCs), bullet swaps, and forwards contracts were promulgated in February 2004. Under the proposed regulations, payments to terminate NPCs, bullet swaps, and forward contracts are deemed to constitute the termination of a right or obligation with respect to the contract and therefore give rise to capital gain or loss if the contract is a capital asset in the hands of the taxpayer. This regulatory interpretation is based on the view that section 1234A(1) provides that the termination of a contract that is a capital asset gives rise to gain or loss regardless of whether the contract is with respect to property that is or would be a capital asset in the hands of the taxpayer. Thus, it is unclear whether these regulations, which have been proposed for almost a decade, comport with the legislative history of section 1234A.

Section 1234A continues to be a source of confusion for taxpayers. If section 1234A is applied to the termination of a contract that is not held by a dealer in those contracts (that is, is a capital asset) without regard to whether the contract relates to property that is a capital asset, section 1234A would apply to all terminations of regular business service and inventory contracts and would convert gain or loss on the terminations of those contracts to capital gain or loss. This is contrary to some private rulings the IRS has issued dealing with payments to terminate burdensome uneconomic fuel transportation contracts (see, for example, TAM 200452033<sup>55</sup>). Moreover, it is worrisome if section 1234A applies to convert an ordinary loss into a capital loss in all situations in which a burdensome contract is terminated at a loss.

Although section 1234A has been amended several times since 1981, uncertainty remains, and another legislative clarification is appropriate. The tax law continues to chase the newest butterflies, but all too often overreaches and snares the worker bee.

<sup>55</sup>Doc 2004-24263, 2004 TNT 248-9.

### Appendix. Timeline of Important Developments Regarding the Straddle Rules

Year	Development	
1981	<b>Economic Recovery Tax Act</b> acts sections 1092 and 263(g).	← Some effective dates
1983	<b>Technical Corrections Act of 1982</b> changes “unrealized gain” to “unrecognized gain” in section 1092; other technical corrections.	
1984	<b>Deficit Reduction Act of 1984</b> classifies stocks as personal property, creates QCC exception.	← Some effective dates
1985	<b>T.D. 8007</b> Regs. 1.1092(b)-1T (coordination of deferral and wash sale rules), -2T (holding periods), and -5T (definitions); <b>T.D. 8008</b> Regs. 1.1092(b)-3T (mixed straddles) and -4T (mixed straddle account).	
1987	<b>Tax Reform Act of 1986</b> adds special rules on foreign currency, amounts received for loaning securities.	
1988	<b>Rev. Rul. 88-31</b> (stock + cash settlement rights = straddle). <b>Technical and Miscellaneous Revenue Act of 1988</b> adds section 1092(b)(2)(D).	
1993	<b>T.D. 8491</b> issues Reg. 1.1092(d)-1 (definitions and special rules).	
1995	<b>T.D. 8590</b> issues Reg. 1.1092(d)-2 (personal property), 1.246-5 (substantially similar or related property).	
1997	<b>Taxpayer Relief Act of 1997</b> amends section 1092(f)(2).	
1999	<b>PLRs 199925044</b> (collar had two straddles) and <b>199940007</b> (DECS-like instruments were cash settlement collars, not debt).	
2000	<b>T.D. 8866</b> issues reg. 1.1092(c)-1, redesignated (c)-2 in 2002 (equity options with flexible terms). <b>TAMs 200033004</b> and <b>200049006</b> (options on stock index did not create straddle against portfolios). <b>Community Renewal Tax Relief Act of 2000</b> provides securities futures contract can be offsetting position.	
2001	<b>PLRs 200131015</b> and <b>200150012</b> (straddles in DECS-like securities).	
2002	<b>Notices 2002-47</b> and <b>2002-50</b> (describe tax shelters with straddles); see also <b>Notice 2003-54</b> , <b>TAM 200509022</b> . <b>T.D. 8990</b> issues reg. 1.1092(c)-1 (qualified covered calls), -3 (qualifying over-the-counter options), and -4 (definitions issued; reg. 1.1092(c)-2 amended). <b>Rev. Rul. 2002-66</b> (QCC + put option situations described).	
2004	<b>American Jobs Creation Act of 2004</b> revises identified straddles treatment, eliminates stock exception except for QCCs.	← Some effective dates
2005	<b>PLRs 200530027</b> and <b>200541040</b> (straddles in DECS-like instruments). <b>Gulf Opportunity Zone Act of 2005</b> adds section 1092(a)(2)(C), which becomes (D) in 2007; requires Treasury to specify rules for identifying identified straddles.	
2007	<b>Tax Technical Corrections Act of 2007</b> amends identified straddle changes of 2004; Treasury to prescribe regulations where position is debt.	

Source: Prepared by John Ensminger.