REPORT #868

TAX SECTION

New York State Bar Association

COMMENTS ON "SHORT-AGAINST-THE-BOX" PROPOSAL

March 1, 1996

Table of Contents

TAX SECTION

New York State Bar Association

March 1, 1996

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Proposed Legislation Regarding "Short-Against-The-Box" Transactions

Dear Secretary Samuels:

Enclosed please find a report of the New York State Bar Association Tax Section on the proposed legislation concerning "short-against-the-box" transactions (the "Proposal"). The principal authors of the report are Samuel J. Dimon, a meber at large of our Executive Committee, and Deborah L. Paul, a Co-Chair of our Committee on Financial Instruments.

The report supports the Proposal, but expresses concern that lack of clarity regarding its scope would create costly uncertainty for transactions that the Proposal was not meant to reach. Clarification of the scope of the Proposal is, therefore, extremely important. In this regard, the report suggests methodologies for analyzing whether a constructive sale has occurred, and provides examples and a safe harbor that might be included in legislative history. The report offers additional technical comments on a number of issues raised by the Proposal, including the definition of a position, the types of property covered, and possible effects of a constructive sale beyond requiring taxpayers to recognize gain.

We would, as always, be pleased to work with you in finalizing the Proposal and in addressing any further issues that arise. Please contact me if we can be of further assistance.

Very truly yours,

Richard L. Reinhold
Chair

[Enclosure]

cc: The Honorable Cynthia G. Beerbower
Deputy Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Glen A. Kohl, Esq.
Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON FINANCIAL INSTRUMENTS

--

COMMENTS ON “SHORT-AGAINST-THE-BOX” PROPOSAL

March 1, 1996

I. Introduction.[1]

This report comments on the recently released legislative proposal regarding “short-against-the-box” and similar transactions (the “Proposal”). A copy of the Joint Committee on Taxation Staff Description of the Proposal, preliminary statutory language, and the Department of the Treasury's description of the Proposal are attached as Exhibits A, B, and C, respectively.[2]

In brief, the Proposal finds a constructive sale when a taxpayer substantially eliminates both risk of loss and opportunity for gain in appreciated stock, debt instruments, and partnership interests (but not in other investments, such as commodities or real estate). The Proposal also has an anti-abuse provision for transactions marketed as having this effect. The appreciated property is deemed sold (and effectively treated as repurchased) for its fair market value on the date of the constructive sale. If the taxpayer constructively sells only some appreciated property, the Proposal adopts a first-in-first-out approach, deeming the taxpayer to sell the property acquired first.

A core case addressed by the Proposal is a short-against-the-box transaction with respect to shares of stock. In

---

[1] The principal authors of the report are Samuel Dimon and Deborah Paul. Substantial contributions were made by David Schizer and Daniel Shefter. Helpful comments were received from Kimberly S. Blanchard, Dan Breen, Peter C. Canellos, Dale S. Collinson, Charles Cope, Peter Furci, Nicholas Gunther, David Hariton, Ann Bilker, Bruce D. Haims, Bruce Kayle, Stephen B. Land, Carolyn Joy Lee, Carlyn McCaffrey, David S. Miller, Erika Nijenhuis, Greer L. Phillips, Yaron Z. Reich, Richard L. Reinhold, Robert H. Scarborough, and Dana L. Trier.

[2] In evaluating the Proposal, we have relied on each of these sources. Although we understand that the released statutory language is preliminary, it is the only proposed language available.

such a transaction, the holder of appreciated stock borrows and sells identical shares. By holding two precisely offsetting positions, one short and the other long, the taxpayer is insulated from economic fluctuations in the value of the stock. While the short-against-the-box is in place, the taxpayer can generally borrow a substantial portion of the value of the appreciated long position. Economically, the transaction strongly resembles a current sale.

Under current law, short-against-the-box transactions generally do not trigger gain on the appreciated "box" stock unless and until the taxpayer uses the appreciated stock to close out the short position.[3] Such treatment is an exception to the general rule that a taxpayer is treated as disposing of an asset if the taxpayer disposes of the benefits and burdens of ownership, including risk of loss and opportunity for gain.[4] The benefits and burdens test aims to treat transactions in accordance with their economic substance, while the current law treatment of short-against-the-box transactions relies

---

[3] See, e.g., Bingham v. Commissioner, 27 B.T.A. 186 (1932); Rev. Rul. 72-478, 1972-2 C.B. 487.

[4] See, e.g., Frank Lyon v. United States, 435 U.S. 561 (1978) (ownership depends on "economic substance"); Grodt & McKay Realty v. Comm'r, 77 T.C. 1221 (1981) (ownership depends on, among other factors, which party bears "risk of loss" and which party receives profits); Bradford v. United States, 444 F.2d 1133 (Ct. Cl. 1971) (zero holding period for taxpayer that acquired shares subject to forward contract obligation to sell); Rev. Rul. 82-150, 1982-2 C.B. 110 (owner of deep in-the-money option to purchase non-traded stock of foreign corporation is actual owner of stock for foreign personal holding company purposes). Cf. Morgan Pacific Corp. v. Comm'r, T.C. Memo. 1995-418 (1995) (note holder's agreement with shareholders of note issuer to swap debt return for equity return consistent with debtor/creditor relationship).

See also Faber, Determining the Owner of an Asset for Tax Purposes, TAXES 795 (December 1983) (right to capital appreciation and depreciation are most important "sticks in the bundle" of ownership); Kleinbard, Risky and Riskless Positions in Securities, TAXES 783 (December 1993) (traditional economic risk and reward test applies to non-fungible assets, while ownership of fungible securities depends on ability to convey formal ownership and market risk).

principally on the taxpayer's continued formal ownership of the shares in the box (as well as the identification rule of Treas. Reg. § 1.1012-1(c)) to conclude that the taxpayer has not sold the box shares. Because of the formalism inherent in the current law treatment of short-against-the-box transactions and such transactions' economic similarity to actual sales, we are supportive of Treasury's desire to conform the tax treatment of short-against-the-box transactions (and economically similar transactions such as “total return” equity swaps) to the treatment of actual sales.

The extension of the statute beyond these core cases creates significant ambiguity for transactions that may not be within the intended reach of the statute. Two approaches could be taken to deal with this issue. First, the statute could be confined to the core cases involving complete elimination of risk of loss and opportunity for gain, with other cases included through prospectively-effective regulations. Compare Sections 246(c)(4)(C) and 1092(d)(3)(B)(i)(II). Alternatively, the statute could be drafted to cover the core cases as well as transactions that closely approximate the core cases; we read the Proposal to reflect this latter approach. Given the reality that an almost infinite variety of transactions can be designed to reduce or eliminate risk of loss and opportunity for gain (for tax-motivated as well as non-tax-motivated reasons), we recognize that the first approach would likely be ineffective, and, therefore, we agree with the general approach taken. The issue then becomes how to deal with the potential over-breadth of the measure. As the technical comments below demonstrate, the Proposal raises many complex interpretive questions and will create real uncertainty, and concomitant costs, unless guidance is offered promptly in legislative history and in regulations or published rulings. A vague statute with little guidance will affect many types of transactions in unforeseen ways, which could lead to costly and unnecessary market distortions and inefficiencies.

As one means of addressing the problem of vagueness, we recommend that the Proposal include in the grant of regulatory authority the power to provide safe harbors and to exclude from the scope of the Proposal transactions that are not viewed as abusive.[5] If that suggestion is followed, the legislative history should include as much concrete guidance as possible regarding Congress' intent as to appropriate safe harbors and other limitations.

We recognize that lawmakers are operating under difficult circumstances in the current legislative environment. We would urge, however, that lawmakers recognize the Proposal's potentially dramatic range of application to many taxpayers and transactions. If the Proposal is enacted, further guidance will be very important.

II. Summary of Technical Comments.

A. Part III discusses issues presented in determining what constitutes substantial elimination of risk of loss and opportunity for gain. The substantial elimination test is more demanding than the "reduction" and "diminution" of risk tests under Sections 246 and 1092 and is conjunctive. A constructive sale is triggered only upon substantial elimination of both risk of loss and

[5] As an example of that approach, Section 355(d)(9) requires the Secretary to prescribe regulations necessary to carry out the statute's purposes, and its legislative history authorizes the Treasury "to exclude transactions . . . to the extent consistent with the purposes of the provision." H. Rep. No. 101-881, 101st Cong., 2d Sess. 344 (1990).

opportunity for gain.[6] The key question under the substantial elimination standard is how much risk of loss or opportunity for gain a taxpayer must retain in order to avoid a constructive sale. To clarify this point, Part III describes possible methodologies for evaluating whether sufficient risk and opportunity have been retained, and also suggests examples and a possible safe harbor that could be included in legislative history.

B. Part IV considers various technical issues that arise in defining a “position”: aggregation and disaggregation of hedges, cases involving partnerships and related-party transactions, timing issues, and specific questions involving “appreciated” short positions and tracking stock. While it may be appropriate to disaggregate a hedge of an appreciated financial position into its component parts, we believe that it is not generally appropriate to disaggregate the appreciated financial position itself for purposes of determining whether the substantial elimination test is satisfied.

C. Part V discusses the Proposal's application to debt instruments. The Proposal's requirement that positions be with respect to “the same or substantially identical property” will significantly -- and, we believe, appropriately -- limit application of the Proposal, excluding most common hedging transactions (e.g., interest rate swaps) entered into by holders of debt

[6] Though the Proposal includes another test for options, which inquires whether the option is substantially certain to be exercised, Part III recommends that this test should be relevant only insofar as it illuminates the ultimate inquiry, i.e., whether the option substantially eliminates risk of loss and opportunity for gain in appreciated property.

securities. Part V also considers the Proposal's application to nonmarketable securities and to conditional sales.

D. Part VI considers the effect of a constructive sale. It discusses the Proposal's "first-in-first- out" rule for sales of less than all the appreciated financial position. Part VI also considers the Proposal's collateral effects, namely, whether the constructive sale is a sale for purposes other than gain recognition.

E. Part VII explores special cases. It questions whether a special rule is needed for interests in a publicly-traded trust. Part VII also recommends an exception for shares in a housing cooperative. Finally, Part VII recommends that the Proposal not trigger a constructive sale on exchanges that otherwise would be tax-free under Sections 351, 368, or 721.

III. Substantial Elimination of Risk of Loss and Opportunity for Gain.

A. Elimination versus Reduction.

1. The Proposal applies to transactions that "substantially eliminate" risk of loss and opportunity for gain. We understand that it is intended to cover a narrower set of transactions than would be covered under a risk "reduction" or "diminution" test. Cf. Sections 246 and 1092.

2. If that is correct, it should be clarified that "substantially eliminates" risk of loss and opportunity for gain means "the elimination of substantially all" such risk and opportunity, rather than the more expansive "elimination of a substantial amount" (or "elimination of a not insubstantial amount") of such risk and opportunity. The latter standard could result in a constructive sale if a taxpayer did not <u>retain</u> substantially all such risk and opportunity.

3. As we understand it, the Proposal generally does not accord any independent significance to the counterparty credit risk inherent in many hedging transactions. In many transactions, such as a short-against-the- box, counterparty credit risk is nonexistent or negligible and therefore taking such risk into account would not make any difference. In other cases, consideration of counterparty credit risk could prove to be complicating and potentially in-administrable in determining whether the taxpayer's risk of loss was substantially eliminated.

B. <u>Conjunctive Test</u>.

1. The Proposal provides two examples, a short-against-the-box and an equity swap, in which <u>all</u> the risk of loss and <u>all</u> the opportunity for gain with respect to the appreciated financial position

are (presumably) eliminated.[7] The Proposal does not, however, provide a general approach for quantifying the risk of loss and opportunity for gain in other cases in order to determine whether such risk or opportunity has been substantially eliminated.[8] Moreover, the Proposal does not explain the proper application of the conjunctive test in cases where some risk of loss and opportunity for gain is retained.

2. We understand the Proposal to provide that if a taxpayer retains either a sufficient portion of the risk of loss (but no opportunity for gain) or a sufficient portion of the opportunity for gain (but no risk of loss) with respect to an appreciated financial position, a constructive sale will not have occurred.

3. Should the risk of loss and the opportunity for gain retained by the taxpayer be aggregated to determine whether the retained risk and opportunity is sufficient to avoid constructive sale treatment? Suppose that a taxpayer retains some risk of loss and some opportunity for gain with respect to an appreciated financial position, neither of which

[7] Total elimination of risk of loss and opportunity for gain is present in the short-against-the-box, and in conventional "total return" equity swaps (but not in certain other equity swaps, e.g., swaps with embedded collars).

[8] The Proposal does provide a "substantial certainty of exercise" test for analyzing whether an option triggers a constructive sale. See Part III.C, below, for a discussion of this test.

alone constitutes sufficient risk or opportunity to avoid a constructive sale. The taxpayer should nevertheless not be deemed to have made a constructive sale if the retained risk and opportunity, taken together, are sufficient.

The Proposal, as we understand it, aims to require sale or exchange treatment when a taxpayer enters into a transaction that is substantially equivalent to an actual sale or exchange of the underlying position. Since an actual sale or exchange generally eliminates all the risk of loss and opportunity for gain, it seems appropriate to consider both retained risk and opportunity together in determining whether a constructive sale has occurred.[9]

C. Options/Substantial Certainty Test.

1. As we understand it, the fundamental inquiry under the Proposal is whether the hedge “substantially eliminate[s] both risk of loss and opportunity for gain on the appreciated financial position.” Though the Proposal suggests a second test for options -- “whether there is substantial certainty that such call or put option will be exercised” -- this test should be relevant only insofar as it bears on the ultimate question of elimination of risk of loss and opportunity for gain. If the standards would otherwise lead to

[9] This approach is arguably in tension with the statutory language, because the requirement that both risk of loss and opportunity for gain be substantially eliminated could be read to suggest that risk and opportunity should be evaluated separately. See Part III.D.5, below, for further discussion of this approach.

different results, the substantial elimination test should control. It would be helpful if this point were clarified.[10]

Assume, for example, that a taxpayer holding a substantially appreciated interest in a two-partner partnership acquires an option to sell its interest to the other partner at any time during the next five years for its appraised fair market value at the time of sale. Even if the taxpayer is substantially certain to exercise its option (e.g., because it is legally obligated to divest itself of the partnership interest, which under the partnership agreement can only be sold to the other partner), there should not be a constructive sale, because the taxpayer has not currently transferred the economic benefits and burdens of ownership or otherwise engaged in a transaction resembling a current sale.

The discussion that follows generally analyzes options with reference to substantial elimination of risk of loss and opportunity for gain, without special focus on substantial certainty of exercise.

[10] While the language regarding substantial certainty of exercise could arguably be eliminated, it does serve a function in negating an overbroad interpretation of the Proposal. See Part IV.E.1.a, below, for an example illustrating this point.

D. Determining Whether Substantial Elimination Has Occurred.

1. Determining whether the taxpayer has substantially eliminated the risk of loss and opportunity for gain with respect to an appreciated financial position is difficult even if the position is readily marketable and has an ascertainable current market value. The expected yield and volatility of the underlying position and the specific terms of the hedge would all seem relevant. Accordingly, it may not be possible for the Proposal, or the Treasury regulations promulgated there-under, to provide a single, bright-line methodology for all transactions.

2. In measuring the retained risk of loss or opportunity for gain, “locked-in” amounts that do not depend on changes in value of the underlying asset should generally be excluded. For example, if a taxpayer holds a stock that is trading at $100, and enters a forward contract to sell it in one year at $105, the locked-in “gain” of five dollars (which is a function of the time value of the deferred sale price, adjusted for anticipated dividends) should not be viewed as retained opportunity for gain for purposes of the Proposal because the taxpayer is entitled to receive $105 upon settlement of the forward contract regardless of the trading price of the stock at the time of

settlement. Cf. Section 1258.[11]

3. To illustrate the difficulty of measuring risk of loss and opportunity for gain, consider a taxpayer who owns a share of common stock that is currently trading at a price of $100. The maximum amount that a taxpayer could “lose” over any time period with respect to this share of stock is $100. Accordingly, one might initially conclude that if a taxpayer purchased a put option with an exercise price of, say, $90, the taxpayer has retained only 10% of the total risk of loss with respect to the share of stock. On closer examination, however, the analysis is significantly more complex, because the likelihood that the stock will trade between $100 and $90 is considerably greater than the likelihood that the stock price will drop close to zero during the term of the option. Accordingly, some element of probability should be taken into account in quantifying the risk of loss with respect to the

[11] There is a related question whether the retention of dividend rights with respect to a stock that is actually or effectively sold forward constitutes retained opportunity for gain (or risk of loss, in the sense that dividends may be lower than anticipated). Dividends are, of course, an important economic attribute of stock ownership and therefore the right to receive dividends might in some cases be a significant factor in determining whether risk and opportunity have been substantially eliminated. For example, a forward contract to sell a high-dividend stock without adjustment on account of intervening dividends might not substantially eliminate opportunity for gain. It is probably necessary, however, to disregard such rights for purposes of formulating safe harbors or indicative examples. On the other hand, it would be helpful to clarify that “gain” generally includes rights to ordinary income (other than any built-in interest, as discussed in the text).

stock.[12]

4. Quantifying the opportunity for gain with respect to an appreciated financial position is subject to additional complexity, since a security, especially a common equity security, generally has no maximum value. For example, a share of stock that is currently trading at $100 has unlimited upside potential since the stock price is not subject to any ceiling. Nevertheless, any rational investor realizes that the practical opportunity for gain with respect to any security has its limits.

5. Option Pricing Approach.

While risk of loss and opportunity for gain can be quantified in numerous ways, one potentially useful approach relies on option pricing. Options help quantify risk of loss and opportunity for gain because they represent the right to eliminate the risk of loss (in the case of put options) and to participate in the opportunity for gain (in the case of call options) with respect to the underlying property during the option's term. Option pricing offers one model for quantifying both the total risk of loss and opportunity for gain over the relevant period, as well as the portions of these quantities that the taxpayer has

[12] One factor to be taken into account in that probability analysis is the period of the hedge. Thus, if, in the above example, the taxpayer's put option at $90 expires one week after it is purchased, this put option is far less likely to be exercised -- and thus will eliminate a much lower percentage of the taxpayer's risk of loss with respect to its stock -- than a put option that has a longer (e.g., three-year) exercise period.

retained.[13] The retained risk of loss could be expressed as a percentage of the total risk of loss, and the retained opportunity for gain could be expressed as a percentage of the total opportunity for gain.[14]

For example, suppose one wanted to quantify the opportunity for gain over the succeeding one-year period with respect to a share of stock that is currently trading at $100. Disregarding dividends on the stock, a one-year call option with an exercise price of $100 would capture 100% of the opportunity for gain above $100 with respect to the stock, since any appreciation in the stock over the succeeding one-year period would inure to the benefit of the holder of the call option. Moreover, if this call option had a value of $20, one could argue that the value of 100% of the opportunity for gain with respect to the share of stock over the succeeding one-year period was worth $20.

---

[13] As illustrated by the option pricing discussion that follows, we would suggest that the relevant period for option pricing analysis should be the term of the options actually entered into by the taxpayer. An alternative approach that focuses on the taxpayer's risk or opportunity with respect to incremental price changes at a particular point in time is discussed at Part III.D.6, below.

[14] Alternatively, under the aggregate approach discussed below, total <u>retained</u> risk <u>and</u> opportunity could be expressed as a percentage of total risk and opportunity.

Similarly, quantifying total risk of loss can be accomplished by reference to the value of put options over a particular time horizon. For example, if a one-year put option on the same share of stock with a strike price of $100 was priced at $15, it can be argued that the total risk of loss with respect to the share of stock over the succeeding one-year period is valued at $15.

Assume that a taxpayer that owns a share of stock worth $100 enters into a transaction that eliminates the taxpayer's entire opportunity for gain with respect to the share for one year by selling a one-year call option with a strike price of $100. In addition, assume the taxpayer also purchases for $10 a one-year put option with a strike price of $90. The taxpayer has retained all the risk of loss related to a decline in the price of the share from $100 to $90, but has eliminated any of the risk of loss to the extent the stock price falls below $90. If the total risk of loss with respect to the share over this one-year period is valued at $15 (equal to the value of a one-year put option with a strike price of $100), then the value of the risk of loss between $90 and $100 (which the taxpayer has not diminished) is $5 (equal to the $15 value indicated for total downside risk below $100 minus the $10 that the taxpayer pays for the put). Accordingly, the option pricing approach indicates that the taxpayer has retained approximately one-third ($5/$15) of the total risk of loss with respect to the share of stock.

Once the retained risk of loss and opportunity for gain have been quantified as percentages, it must be determined whether such retention is sufficient for purposes of the statute. For administrative convenience, it may be appropriate to provide that retaining at least a specified percentage, e.g., 10% to 20%, of either risk of loss or opportunity for gain would create a presumption that a constructive sale has not occurred.[15] If this suggestion is adopted, no negative inference should be drawn from failure to meet the specified standard.

As discussed in Part III.B., above, in cases where the taxpayer has retained both risk of loss and opportunity for gain, it would seem appropriate to aggregate this retained risk of loss and opportunity for gain for purposes of determining whether a constructive sale has occurred. Under this methodology, the value of the risk and opportunity retained could be expressed as a single fraction. The numerator would be the sum of the absolute values of risk and opportunity retained for the relevant period, and the denominator would

[15] We question whether a safe harbor (as opposed to a presumption) would produce satisfactory results in all cases if risk of loss and opportunity for gain were evaluated separately. For example, a safe harbor might inappropriately protect a taxpayer that hedges a debt security issued by a foreign government if, at the time of testing for a constructive sale, the security 1) has one year remaining to maturity; 2) pays no interest prior to maturity; 3) pays an amount at maturity equal to the issue price of the bond plus a contingent amount of interest based on a highly volatile stock index e.g., the equivalent of an embedded option that is at-the-money at the time of testing); and 4) has a fair market value equal to its par value. Measured in terms of gross dollars, the security has relatively low downside risk compared to its upside potential. Intuitively, retaining 10% or even 20% of the downside risk seems less significant than retaining such a percentage of the opportunity for gain.

be the sum of the absolute values of the security's total risk and total opportunity for such period, as determined using option prices.[16] If this approach is adopted, a smaller percentage of aggregate retained risk of loss and opportunity for gain should suffice to avoid a constructive sale (because the denominator of the relevant fraction will be larger, as it will include the total of both risk of loss and opportunity for gain).

Using option prices to calculate retained risk of loss and opportunity for gain has several limitations. First, determining prices of the relevant options in the absence of a liquid market in such options is difficult. Although there are mathematical models, such as the Black-Scholes equation, that could be used, those models are complicated and entail some level of subjectivity (e.g., in assessing the volatility of the underlying stock).[17] Second, the option pricing approach assumes a single relevant time horizon. In the discussion above, a one-year horizon was used.

---

[16] A virtue of this aggregate approach -- as opposed to an approach that adds separately-calculated gross percentages of retained risk and opportunity -- is that it yields a meaningful measure even in cases, such as the one described in footnote 15, in which the probability distribution for a security may be skewed. Retention of 10% of the downside risk and 10% of the upside potential with respect to such a security seems less meaningful than retention of 20% of the upside potential. Rather than simply adding the two percentages together (e.g., 10% plus 10%), it would seem more appropriate to use the approach based on a single percentage.

[17] If the underlying stock itself is not publicly-traded, so that the price of the stock as well as its volatility are difficult to quantify, option pricing would seem of even lesser utility.

In the case of some hedges, there may be no obviously appropriate horizon. If, for example, a taxpayer hedges its position in stock using several options with different maturities, it is unclear how retained risk of loss and opportunity for gain should be calculated. Option pricing analysis may not be particularly useful in such a context.

Even where the value of an option can be precisely ascertained (as in the case of a traded option), we would not suggest that option pricing should be viewed as the only means of evaluating retained risk of loss or opportunity for gain. For example, evidence regarding the fundamentals of the underlying business could also be relevant in establishing a range of expected future stock values, which in turn could bear on whether sufficient risk of loss and opportunity for gain was retained.[18]

6. Delta Analysis/Dynamic Hedging

One possible alternative to option pricing analysis as a means of quantifying retained risk and opportunity would be to examine the extent to which the value of the taxpayer’s overall position would

[18] As we understand it, option prices are based on financial variables, including forward prices and volatility, in a manner that does not take account of the “risk premium” that the market assigns to the underlying stock, which reflects an assessment of the issuer's prospects. Accordingly, the option pricing approach may not measure perfectly the risk of loss and opportunity for gain retained by a taxpayer (or the likelihood that a particular option will be exercised). Taxpayers should not be foreclosed from introducing evidence regarding expected price.

change if the value of the taxpayer’s appreciated financial position changed by, say, $1. For example, suppose the taxpayer initially owned stock and then hedged by selling four out-of-the-money calls. Depending on the value of the stock, each call might increase in value by $0.25 if the value of the stock increased by $1 (and decrease in value by $.25 if the value of the stock decreased by $1). If so, arguably, the taxpayer is fully hedged. An increase in the value of the stock by $1 changes the taxpayer’s new overall position by $0 (equal to $1 increase in the taxpayer’s stock minus a total of $1 increase in the value of the taxpayer’s written calls); similarly, a $1 decrease in stock price leaves the taxpayer's overall position unaffected. This approach to determining whether the taxpayer has substantially eliminated risk and opportunity relies on a financial concept known as “delta,” which measures the rate at which a derivative security changes in value if the underlying asset changes in value by an incremental amount.[19]

[19] Option prices depend on, among other variables, the value of the underlying asset. For example, the value of a call option could be plotted against the value of the underlying asset as a curve that rises as the asset value increases. Delta is the slope of that curve. Delta analysis is used by arbitrageurs to take advantage of mispricing in the market. An option trader can create a portfolio with an overall delta of zero, consisting of long and short positions, including options, in the underlying. (The trader will need to rebalance the mix of options and other positions at frequent intervals to maintain a delta- neutral position.) Assuming that delta hedging is carried out and functions as intended, at any given time the trader will have eliminated any net exposure to incremental price changes in the underlying asset and will therefore be able to capture price differentials without taking risk. Delta analysis is also used to quantify risk exposure of a risky portfolio: for example, it is employed by portfolio managers to quantify the price protection offered by a put option.

“Delta” analysis has certain arguable advantages when compared to the option pricing approach described above. For example, it circumvents potential difficulties in establishing a relevant time horizon, since it examines the effect of an incremental change in the price of the underlying asset on the value of the hedge (or hedges), without reference to the maturity date of the hedges.

While delta analysis may prove relevant in particular cases, it also has limitations. First, it is based on mathematical models which, while they may prove relatively precise in many cases, may also be too esoteric to be administrable (a concern that is also present in applying option pricing analysis).

Second, delta analysis measures the taxpayer's sensitivity to incremental changes in the underlying asset. Such sensitivity varies whenever the value of the underlying asset changes. In the above example involving a taxpayer that owns stock and sells four out-of-the-money calls, the taxpayer would need to rebalance its position at frequent intervals by buying or selling options, stock, or other positions in the stock in order to maintain a relatively risk-free position (and failure to monitor the position during times of sharp market fluctuations could largely obviate the value of the hedge). It is debatable whether a constructive sale should arise in such a case, where the taxpayer enters into a "dynamic" hedge that substantially eliminates risk and opportunity only for an instant -- and not for a longer period unless the taxpayer engages in new "rebalancing" transactions.

The language of the Proposal requires substantial elimination "for some period." If this phrase includes substantial elimination "for an instant," then dynamic hedging would seem to be covered. However, the more natural reading of the phrase "for some period" would appear to be that it connotes a length of time longer than an instant. Moreover, dynamic hedging does not have the "feel" of a current sale; it involves an ongoing series of transactions, rather than a single event in which the taxpayer surrenders the benefits and burdens of ownership. Cases involving dynamic hedging are distinguishable from "core" cases of a short-against-the-box and a "total return" equity swap.[20]

At the same time, it would be a mistake to exclude dynamic hedging from the substantial elimination test if doing so would lead to substantial abuse. He do not anticipate such abuse, however. At present, dynamic hedging is conducted by dealers that are already exempt from the Proposal because they mark to market under Section 475, and by

[20] If the phrase "for some period" does indeed require substantial elimination for more than an instant, as we believe it should, then it could be difficult, as an administrative matter, to cover dynamic hedging under the substantial elimination test, because it will be difficult to determine whether a taxpayer has rebalanced the taxpayer's portfolio frequently enough to maintain substantial elimination of risk and opportunity "for some period."

traders that hedge dynamically for their own account.[21] Non-dealers that use a third party agent to effect dynamic hedging for an appreciated position may be covered by the Proposal's marketing test -- a separate way to trigger a constructive sale. On balance, we do not believe that traders and non-dealers that dynamically hedge using a third party agent present enough of a concern to justify the administrative complexity of applying the Proposal to dynamic hedging.

7. In sum, although the option pricing approach and the delta approach are appealing because they involve apparently objective financial concepts, we are cautious about the tax regime’s practical ability to use those concepts. Moreover, we recognize that, at least in some cases, there may be questions about the appropriateness of these approaches for purposes of determining whether a constructive sale has occurred. Although we recommend against using either approach as an exclusive method for measuring risk and opportunity, we believe they may be useful in some contexts, as illustrated by the use of option pricing analysis in the example described in Part III.E.2, below.

---

[21] Traders do not generally mark to market dynamically hedged positions in single equities. Cf. Section 1256 (“dealer equity options” and “non-equity options” marked to market).

E. Examples.

1. In order to provide taxpayers with practical guidance as to the scope and application of the substantial elimination standard, it would be extremely helpful if examples of specific transactions were included in legislative history and in the Treasury regulations or published rulings. The following specific examples could be so included.

2. Portfolio Exchangeable Instrument.

Taxpayer, a domestic corporation, owns one million shares of common stock of the ABC Corporation (the "ABC Stock"). The ABC Stock represents 20% of the total outstanding common stock of ABC Corporation. The remaining 80% of the ABC common stock is widely-held and publicly-traded. (Accordingly, taxpayer and ABC are not related parties within the meaning of Section 267(b).) Taxpayer purchased the ABC Stock for $20 per share in 1992 and it is currently trading at $100 per share. On January 1, 1997, taxpayer issues one million debt securities (the "Exchangeable Debentures") to investors (the "Holders") for cash. Each Exchangeable Debenture is sold for $100 and has a five-year term. During the five-year term, Holders are entitled to semi-annual interest payments of 6% per annum ($6 per debenture). In addition, at the end of the five-year term (the "Maturity Date"), Holders will receive a number (the "Exchange Ratio") of shares of ABC common stock that is determined based on the trading price of the ABC common stock on the Maturity Date or, at the taxpayer's option, an amount of cash equal to the value of such ABC common stock. The Exchange Ratio will be determined according to the following schedule:

Trading Price per Share of ABC Stock on Maturity Date	Exchange Ratio	Cash Equivalent Amount
Less than $100	1.0 share	Value of one share of ABC stock
From and including $100 to and including $115	1.0 share to .87 shares	$100
Above $115	.87 shares	$100 plus 87% of the excess of the value of one share of ABC stock over $115

By issuing the Exchangeable Debentures, Taxpayer appears to have eliminated all or substantially all its risk of loss with respect to the ABC Stock, since any depreciation in the value of the ABC Stock has been shifted to the Holders. (It is arguable that Taxpayer has retained some risk/opportunity with respect to the ABC Stock because it retains all dividend risk/opportunity with respect to the ABC Stock, but the analysis in this example does not rely on this consideration.) For example, if ABC common stock is trading at $80 per share on the Maturity Date, Taxpayer can either deliver one share of its ABC Stock or $80 of cash to retire each Exchangeable Debenture.

Nevertheless, Taxpayer will not be deemed to have made a constructive sale of its ABC Stock if Taxpayer has not substantially eliminated its opportunity for gain with respect to such stock. In support of Taxpayer's assertion that it has retained a sufficient portion of the opportunity for gain with respect to the ABC Stock, Taxpayer's financial advisor has provided the following information regarding the value of five-year call options on shares of ABC common stock:

Strike Price	Value of Call Option
$100	$35
$115	$25

Based on these option prices, the value of 100% of the opportunity for gain with respect to a share of ABC stock over the five-year term of the Exchangeable Debentures is $35. Moreover, the value of the opportunity for gain that has been retained by Taxpayer with respect to each share during the five-year period is at least $10 (equal to the excess of the $35 value of all the opportunity for gain above $100 over the $25 value of the opportunity for gain above $115).[22] Thus, Taxpayer

[22] There is a question whether the value of the retained call at $115 with respect to 13% of Taxpayer's position should be viewed as a call providing 13% of the upside with respect to all of Taxpayer's stock holdings, or whether it should more appropriately be viewed as indicative of the retention of all of the upside with respect to 13% of Taxpayer's stock. The example in the text, however, can be resolved without reference to that issue.

has retained more than 28% ($10/$35) of the total opportunity for gain with respect to all of its shares of ABC Stock. Accordingly, Taxpayer has retained sufficient opportunity for gain with respect to all the shares of ABC Stock, thereby preventing a constructive sale.

Since the focus of the substantial elimination inquiry is on risk of loss and opportunity for gain, it seems irrelevant whether Taxpayer intends or is required to deliver cash or ABC Stock upon maturity. Thus, for example, whether debt indentures or the securities laws constrain Taxpayer's ability to deliver cash rather than ABC Stock should be immaterial to the constructive sale inquiry. Cf. Rev. Rul. 85-119, 1985-2 C.B. 60 (notes requiring issuer to pay fixed dollar amount of stock or cash treated as debt).

3. Out-of-the-Money Collars.

A typical “collar” is a hedging transaction whereby a taxpayer hedges a portion of its risk of loss and relinquishes a portion of its opportunity for gain by purchasing an out-of-the-money put option (i.e., one whose strike price is below the current stock price) and selling an out-of-the-money call option (i.e., one whose strike price is above the current stock price).[23] Since the put option's strike price

[23] A collar could in effect also be achieved using financial instruments other than options, such as an equity swap or a portfolio exchangeable debt instrument of the type described in Part III.E.2, above.

is below the current stock price, the taxpayer retains the risk of loss between the current stock price and the strike price of the put option. In addition, the taxpayer retains the opportunity for gain between the current stock price and the strike price of the call option. Combined, this risk of loss and opportunity for gain can be substantial, thereby negating a constructive sale. If, on the other hand, the collar is too "tight," the taxpayer may not have retained sufficient risk of loss or opportunity for gain, in which case the collar would be substantially equivalent to an actual sale of the stock.

In order to determine whether a collar is "wide" enough, it might be possible to use the option pricing approach or delta approach to quantify the risk and opportunity retained by the taxpayer. In many situations, however, it may be difficult or costly for taxpayers to obtain the required information.[24] Accordingly, consideration should be given to adopting a safe harbor with respect to collars whose "range" includes the current trading price of the security subject to the collar. For example, a safe harbor might apply to any collar

[24] If the taxpayer worked with a bank or broker to put on the collar, the information might be more readily available.

that has: (i) a relatively short term (e.g., not exceeding three or, alternatively, five years), (ii) a total "spread" of at least 20% of the current trading price of the hedged security, and (iii) a spread that includes the current trading price of the hedged security.

Such a safe harbor would not account for many key factors relevant to the amount of risk and opportunity retained by a taxpayer. For example, such a safe harbor would not consider the volatility of the appreciated security being hedged, the expected current yield (dividends or interest) on the underlying appreciated security, or the term of the hedge (to the extent it is less than three or five years). Accordingly, many collars that do not substantially eliminate the taxpayer's risk of loss and opportunity for gain with respect to an appreciated security would nevertheless fail to qualify for the safe harbor.[25] On the other hand, the safe harbor has the clear merit of being easy to understand and administer and would seem to protect cases that are adequately distinguished from the core cases targeted by the Proposal. We have not undertaken any quantitative analysis to support the suggested safe harbor, however, and note that it would probably be

[25] For example, a one month collar with a range of $95 to $107 that is entered into with respect to a stock trading at $100 may eliminate only, say, 20% of the risk of loss and opportunity for gain (leaving the taxpayer with 80% of such risk and opportunity) given the short-term nature of the hedge. Accordingly, if a safe harbor is adopted, no negative inference should be drawn from failure to satisfy it.

advisable to limit such a safe harbor to collars that hedge appreciated common stock.[26]

The following example illustrates application of this safe harbor. X, an individual, owns 1,000 shares of stock of HIJ Corporation (the “HIJ Stock”), representing less than one percent of the total outstanding stock of HIJ. X purchased the HIJ Stock for $10 per share on March 1, 1993. The stock of HIJ is widely-held and publicly-traded. On January 1, 1997, at a time when the stock of HIJ is trading at $100 per share, X enters into a transaction with a financial institution whereby X purchases a three-year put option with a strike price of $90 and sells a three-year call option with a strike price of $110 (collectively referred to as the “collar”). X receives net proceeds of $8 for entering into the collar since the cost of the put option ($10) is less than the price X receives for selling the call option ($18).

In this example, the put option and the call option are each 10% out-of-the-money (based on the difference between the option's respective strike prices and the trading price of the HIJ Stock at the time the collar is entered into). Collectively,

---

[26] For example, the 20% safe harbor might yield inappropriate results in the context of a security with limited downside, such as the instrument described in footnote 15, or in the case of a warrant, swap or other synthetic security that was designed with particularly high volatility. Although there may also be some concern about applying the safe harbor to highly volatile common stock, the likelihood of inappropriate results in cases involving collars on common stock would seem lower. As noted above, however, we have not undertaken any systematic quantitative analysis of this question.

the options reflect a 20% “spread” between the put price and the call price. In addition, the spread of the collar includes the trading price of the HIJ Stock at the time the collar is entered into. Finally, the three-year term of the option will satisfy the safe harbor's maximum term requirement (of three or, alternatively, five years). Accordingly, entering into the collar will not constitute a constructive sale.[27]

IV. Definition of “Position”.

A. General.

The Proposal applies to a taxpayer that owns an “appreciated financial position” and enters into one or more “positions” with respect to the same or substantially identical property (“SSIP”). The concept of a “position” is relatively straightforward in the case of a short-against-the-box or forward sale of stock. For example, if a taxpayer is long stock and enters into a forward contract to sell identical stock, the latter is clearly a “position” with respect to the stock or substantially identical property. In other transactions, however, the concept of “position” is more difficult to apply.

[27] As discussed below at Part IV.E.1.a, the fact that X's $10 basis is less than the put strike price of $90 should be irrelevant.

B. Integration of Positions.

1. In ascertaining whether a taxpayer has substantially eliminated risk of loss and opportunity for gain with respect to one position, the taxpayer may find that no other position, in isolation, has this effect, but that two or more of them do when considered in combination.

2. Assume, for example, that taxpayer is long stock A, and becomes the short party in two different swaps relating to A: in one, the taxpayer swaps out of depreciation; in the other, appreciation and dividends. Under the Proposal's language, which asks whether a taxpayer has entered "into 1 or more positions . . . which, for some period, substantially eliminate both risk of loss and opportunity for gain . . . ," the taxpayer presumably must integrate the two positions when applying the substantial elimination test, even if the swaps are with two different counterparties. Thus, constructive sale treatment would apply.

C. Disaggregation of Positions.

1. The Proposal raises the question not only of when to integrate more than one position, but also when, if ever, to divide up (i.e., disaggregate) a single position.

2. For example, assume that the taxpayer is long stock A, which has appreciated, and then enters into a

swap under which the taxpayer is "short" a group of stocks that includes A. Under what circumstances would some portion of the swap be deemed a "position" in A, triggering a constructive sale of some or all of the A stock that the taxpayer owns?[28]

If a taxpayer owns a portfolio of shares, then entering into a short position should be exempt from constructive sale treatment if the short position is not "substantially similar or related property" ("SSRP") for purposes of Section 246. Suppose, for example, that the owner of an appreciated portfolio of stocks enters into a short sale of shares of a mutual fund that holds an economically similar but not identical portfolio. If the short mutual fund position is not SSRP with respect to the taxpayer's portfolio under the rule of Treas. Reg. § 1.246-5(c) (70% overlap test for determining SSRP), then the mutual fund position should not be disaggregated into its constituent positions in individual stocks to determine if those stocks are the same as (or substantially identical to) the stocks in the taxpayer's portfolio. A determination that the short position is not SSRP should end the inquiry, because SSIP is a narrower test than SSRP.

---

[28] Cf. Treas. Reg. § 1.246-5(c)(1)(v) (for purposes of determining whether a position is "substantially similar or related property," a position that reflects the fair market value of more than one stock but not of a portfolio, i.e., 20 or more stocks, is treated as a separate position with respect to each of the stocks the value of which the position reflects); Treas. Reg. § 1.246-5(c)(7) (rights and obligations under notional principal contract considered separately, even though payments netted). We assume that, by analogy to Treas. Reg. § 1.246-5(c)(7), a taxpayer holding an appreciated position in stock A would be deemed to have made a constructive sale by entering into a "total return" swap in which the taxpayer was effectively "short" (only) stock A and "long" an index of other stocks.

3. Although it may generally be appropriate in non-portfolio cases to disaggregate a hedge into its component parts, we believe that the taxpayer's appreciated financial position generally should not be disaggregated. Such disaggregation would be difficult to administer and would be at odds with the narrow anti-abuse thrust of the Proposal.

   a. For example, assume that a taxpayer has a “long” position in a swap based on a basket of 5 stocks, including A. If the taxpayer shorts A, there should generally be no constructive sale of the “portion” of the swap that is based on A. Disaggregation would yield a particularly anomalous result where the overall swap is a net liability from the taxpayer's perspective (i.e., where A has appreciated, but this appreciation is more than offset by depreciation in the other underlying stocks).

   b. Economically, there are no “fundamental” assets. Indeed, even a single share of stock could be viewed as a combination of sub-positions, including an embedded long call. If a taxpayer owns stock and sells a call, the taxpayer could be viewed as substantially eliminating risk of loss and opportunity for gain with respect to the long call embedded in the taxpayer's stock. The Proposal is clearly not intended to apply to an example such as this, however (unless the sold call is substantially certain to be exercised).

D. Partnership and Related-Party Transactions.

1. In some circumstances, taxpayers will not hold appreciated positions directly; instead, they will hold interests in partnerships that in turn hold appreciated positions. This raises the question whether to “look through” the partnership interest to the underlying position.

Under the Proposal's related-party rule, a taxpayer holding an appreciated position may be deemed to sell it not only when the taxpayer enters into a hedge, but also when a related person enters into a hedge. Under Section 1259(c)(4), related persons are defined by reference to Sections 267 and 707(b). Under Section 707(b), a partnership is related to any partner who holds more than a 50% interest in the capital or profits of the partnership.

Accordingly, if a taxpayer holds 100 appreciated shares of stock A and also owns a 51% interest in a partnership, the taxpayer may be deemed to make a constructive sale of stock A if the partnership sells short 100 shares of stock A. We presume that in general only 51 of the taxpayer's shares would be deemed constructively sold (rather than 100), although a different calculation would be appropriate in a case involving disproportionate partnership allocations.

2. In other circumstances, a partnership will hold an appreciated position and hedging may be done by a related partner. Assume, for example, that a partnership holds 100 shares of appreciated stock A along with other assets, and partner X has a 51% interest in the partnership. If partner X sells short 51 shares of stock A, presumably the partnership, not partner X, is treated as making a constructive sale -- because the Proposal describes the "taxpayer" as the one holding the appreciated position, and the related party as the one with the hedge.[29] Clarification would be helpful regarding adjustments to the basis and capital account of each partner, as well as the appropriate allocation of gain.

3. In view of the foregoing complexities and the potential for inequitable results, we strongly support limiting the related-party rule to cases involving an intention to avoid constructive sale treatment. Section 1259(c)(4)(B) provides such a limitation.

4. Thus far, the examples have considered partners who qualify under Section 707(b)'s "more than 50%" test. For partners not expressly covered by this related-party rule, is there a negative implication

[29] Even if X's partnership interest is appreciated, the stock sold short would generally not be substantially identical to the partnership interest. Therefore, X would not be viewed as having sold such interest.

that one should not look through the partnership interest? In general, this would seem a sensible approach. To the extent that a partnership is used to achieve an abusive result, the anti-abuse provision of Treas. Reg. § 1.701-2 would presumably be implicated.

E. <u>Timing: Position as of When?</u>

1. In determining whether risk of loss or opportunity for gain has been substantially eliminated, risk of loss and opportunity for gain apparently are measured relative to the value of the taxpayer's appreciated financial position as of the time that the taxpayer enters into the hedge.

   a. The fact that a taxpayer for some period “locks in” a range of values in excess of the basis in an appreciated security should not be determinative of whether the taxpayer has substantially eliminated risk of loss with respect to such security. Rather, both risk of loss and opportunity for gain should be determined with reference to the value of the security at the time the taxpayer enters into the hedging transaction.

      Consider, for example, a taxpayer with a basis of $10 in a share of stock who, at a time when the stock is worth $100, writes a call with a strike price of $100 and buys a put with a strike price of $50. While the options remain open, the taxpayer has eliminated all possibility of future gain and ensured that the value of the overall position will never decline below $50, an amount in excess of basis.[30] The taxpayer should not be deemed to have made a constructive sale, however. The Proposal requires that, in order to trigger a constructive sale, an option must be substantially certain to be exercised. On the facts stated, there is no substantial certainty that either the call option (which is at-the-money) or the put option (which is far out-of-the-money) will be exercised. Thus, the taxpayer's basis (as opposed to the fair market value of the appreciated security) is not an appropriate reference point for determining whether risk of loss and opportunity for gain have been substantially eliminated.

b. Events subsequent to entering into the hedge, moreover, should not as a general matter bring an otherwise non-qualifying transaction under the Proposal.

---

[30] Note that even if the taxpayer did not write a put and merely wrote a call option at $100, for which a $20 premium was received, the taxpayer would have locked in an economic gain (while eliminating all possibility of future gain), because the call premium received was greater than the taxpayer's basis of $10.

Assume that a taxpayer holds stock A, with a basis of zero; when A is trading at $100, the taxpayer writes a call on A with a strike price of $100. Because the strike price equals the market price, the taxpayer does not substantially eliminate the risk of loss by writing the option (though, apart from dividends, the short call does eliminate the taxpayer's opportunity for gain). The call option is not substantially certain to be exercised; accordingly, there is no constructive sale.

The mere fact that the stock subsequently appreciates and the call becomes deep in-the-money should not by itself trigger a constructive sale (nor do we interpret the Proposal to permit such a result). But, suppose that, while the stock is trading at $130, the taxpayer buys a put with a strike price of $100 (i.e., well out-of-the-money) with the same expiration date as the previously written call. By itself, the put is not substantially certain to be exercised; nor does it eliminate the taxpayer's risk of loss as of the date it is entered into, because the stock price is 30% higher than the put exercise price. The taxpayer has, however, in effect ensured that it will sell the stock at $100. It is debatable whether this transaction should give rise to a constructive sale. One point seems clear, however: if there is a constructive sale, it is not appropriate to use the $130 fair market value of the stock at the time the put is purchased as the constructive sales price, because the taxpayer will only receive $100 when the stock is sold.

c. Assume corporation C holds appreciated stock X and issues a security with a five-year term that will be settled in stock X; the number of shares of stock X to be delivered, however, is not set either upon issuance or at maturity. Rather, the number of shares is fixed midway through the term based on the trading price of X thirty months after issuance. Accordingly, for the first thirty months corporation C retains all risk of loss and opportunity for gain. After that point, though, corporation C becomes completely insulated -- by operation of the original contract terms. As measured on the date of issuance, C apparently has not made a constructive sale; but is it treated as making a constructive sale after 30 months? If so, is the theory that once this contract term is triggered, there is a new instrument? Compare Proposed Treas. Reg. § 1.1001-3(c)(2) (no realization event if alteration of debt right or obligation occurs by operation of the original terms of instrument) with Rev.

Rul. 90-109, 1990-2 C.B. 191 (change in contractual terms pursuant to exercise of option contained in original insurance contract was exchange under Section 1001 because substance of original contract was altered in a fundamental way).

F. Short Positions.

Section 1259(b)(2) defines “position” to mean an interest, including a futures or forward contract, short sale or option. We assume that if a taxpayer shorts publicly-traded stock at $100 and subsequently buys the stock at $60, without closing the short position at that time, it is intended that there be gain recognition of $40. If so, we would suggest that the definition of “appreciated financial position” in Section 1259(b)(1) provide that “there would be gain were such position sold, assigned or otherwise terminated” and that similar language be used in Section 1259(a)(1).

G. Tracking Stock.

Would the Proposal treat an issuer of “tracking stock” as having constructively sold stock of the tracked subsidiary? Suppose that Parent Corp issues tracking stock that entitles holders to voting and liquidation rights in Parent Corp but dividend rights determined by reference to the earnings of a subsidiary of Parent Corp. Under what circumstances, if any, would the Proposal treat Parent Corp as having sold subsidiary stock?

V. <u>Types of Property Covered</u>.

A. <u>Positions in Debt</u>.

1. Although the Proposal expressly covers positions in debt, it does not appear to apply to the most common hedging transactions with respect to debt. As discussed below, the Proposal's SSIP requirement should make the Proposal inapplicable to many transactions that hedge positions in debt. We believe that the SSIP requirement reaches appropriate results in many cases and should therefore be retained. If the SSIP requirement were dropped, however, we would recommend curtailing the scope of the Proposal to cover only a narrow class of debt instruments, including convertible and contingent debt.

2. The Proposal's requirement that the hedge be with respect to SSIP should significantly restrict the Proposal's application to debt securities.

   a. “Substantially identical property” in the Proposal presumably has the same meaning as the very restrictive test used in Sections 1091 and 1233. In general, non-contingent debt of different issuers would not be SSIP, even if the issuers have the same credit rating and the instruments have the same maturity and coupon. Even different debt instruments issued by the same issuer are unlikely to constitute SSIP. See P.L.R. 5512154870A (Dec. 15, 1955) (otherwise identical 3 3/4% turnpike bonds and

4 1/8% turnpike bonds not substantially identical); P.L.R. 6112086000A (Dec. 8, 1961) {otherwise identical Treasury bonds not substantially identical where one had a maturity of two years and nine months and the other a maturity of four years and five months). Thus, if a taxpayer owns a debt instrument and enters into a short sale of a debt instrument (or preferred stock) issued by another issuer or having a different interest rate, maturity or seniority, the taxpayer should generally not be treated as having made a constructive sale.

b. The SSIP requirement should also exempt from constructive sale treatment a taxpayer that owns a debt instrument and enters into a swap or a series of forward contracts that offset the taxpayer's exposure to interest rate fluctuations, but does not protect the taxpayer against the risk that the issuer will fail to repay principal. Such swaps and forward contracts are not positions in the underlying debt or in property that is “substantially identical” thereto. Instead, such swaps or forward contracts are positions in themselves, in cash, or in interest rates.

Thus, if the taxpayer effectively converts a fixed rate debt instrument that the taxpayer owns into a floating rate instrument by entering into an interest rate swap under which the taxpayer receives a floating rate and pays the fixed rate, Section 1259 as currently drafted generally would not apply. The swap does not constitute a position with respect to SSIP, because it does not protect the taxpayer against the risk that the principal amount of the debt will not be repaid. In the case of a debt instrument with a negligible or very low risk of default, it is less clear whether a swap with respect to interest only should be treated as a position with respect to SSIP. For example, if a taxpayer that owned an appreciated 30-year U.S. Treasury bond entered into a swap to maturity in which the taxpayer paid an amount equal to the interest payments under the bond and received LIBOR-based payments, should the taxpayer be treated as having constructively sold the bond? The complexities involved in attempting to apply the constructive sale rules to transactions that hedge payments of interest, but not principal, generally counsel against such a course.

c. The Proposal could arguably apply to an obligor's position with respect to its own debt. However, we doubt that such an application is intended, at least with respect to non-contingent debt. Cf. Section 1092(d)(7) (position includes obligor's interest in borrowing in nonfunctional currency for Section 1092 purposes). If there is an intention that the Proposal apply to issuers, the Proposal should be revised to so state.

Assuming that the Proposal could so apply, the SSIP requirement would also exempt an issuer's use of a swap or series of forward contracts to protect against exposure with respect to interest rate fluctuations because such swap or contracts are not SSIP with respect to the issuer's non-contingent debt.[31] Such treatment would again generally seem appropriate. Hedging borrowings is perceived by many as a prudent exercise of business judgment. Indeed, issuance of Treas. Reg. § 1.1221-2 (which prevents character mismatching with respect to hedging transactions) may be seen as an implicit recognition that such hedging is generally not abusive.

We note that, under the foregoing interpretation, an issuer of a debt instrument that has decreased in value can use a swap or series of forward contracts to avoid immediate re-cognition of cancellation of indebtedness ("COD") income -- though it will recognize income on the hedge under applicable timing

---

[31] Similarly, the SSIP standard should mean that an issuer that effects an in-substance defeasance would not be covered by the Proposal. Cf. Rev. Rul. 85-42, 1985-1 C.B. 36.

rules. Such a case could be viewed as analogous to a situation in which a party with an “appreciated” short position uses a swap or forward contract to avoid gain recognition. On balance, we doubt that such a construction of the Proposal justifies the administrative complexity it would entail, and would accordingly suggest that an issuer's position with respect to its debt not be tested as an appreciated financial position.[32]

3. The SSIP requirement also seems to function properly in the case of hedges entered into by holders of convertible or contingent debt. Consider, for example, a holder of an appreciated convertible debt instrument that writes a call with respect to the stock into which the convertible debt converts. On the one hand, assuming that the conversion right is not deep in-the-money, the written call is not SSIP with respect to the convertible debt. Non-application of Section 1259 is appropriate, because the short call does not result in substantial elimination of the holder's risk of loss and opportunity for gain on the long security (e.g., it does not protect against the risk of default on the debt, or interest rate fluctuation). On the other hand, if the conversion right were deep in-the-money, then the written call is apparently a position with respect to SSIP with

[32] We note that debt issuers that intend to hedge their exposure with respect to interest rates or contingent payments often do so at the time the debt security is issued. Thus, even if an issuer's position with respect to its debt were subject to testing as an appreciated financial position, it is not clear that many constructive sales would result.

respect to the convertible debt, since the convertible debt behaves under such circumstances like the underlying stock. See Treas. Reg. § 1.1233-1(d)(1). Whether the written call substantially eliminates risk of loss as well as opportunity for gain with respect to the convertible debt would presumably depend on how deep in-the-money the written call was. The same analysis would apply in the case of a contingent debt security.

4. Elimination of the SSIP requirement would permit application of the Proposal to hedges of debt, including convertible or contingent debt, when the hedge is not a position with respect to SSIP. As described above, however, the SSIP requirement seems in many cases to lead to an appropriate limitation on the scope of the Proposal. Accordingly, if there is a desire to eliminate the SSIP requirement, perhaps non-contingent, nonconvertible debt instruments should be expressly excluded from the Proposal. However, this result could conceivably lead to inappropriate results if shorts-against-the-box or “total return” swaps are entered into with respect to appreciated debt securities. Although such transactions are not common, they might have some appeal in cases involving non-investment-grade debt. On balance, we recommend retaining the SSIP standard.

5. Clarification should be provided regarding the interaction of the constructive sale rules with the integration rules of Proposed Treas. Reg. § 1.1275-6 (governing certain hedging transactions with respect to contingent and variable rate debt instruments) and Treas. Reg. § 1.988-5 (governing certain hedging transactions with respect to nonfunctional currency debt instruments). These regulations permit integration of debt securities and hedges in specified circumstances to create a new synthetic debt security. In the case of contingent debt securities, we have not identified any fundamental inconsistency that prevents application of both the Proposal and the proposed regulations.[33] We do, however, note that a hedging transaction that would qualify for integration under the proposed regulations would not necessarily constitute a position with respect to SSIP, and thus might not be subject to the Proposal. In the case of hedging of nonfunctional currency debt instruments, there is an apparent inconsistency between the requirement of the Proposal that gain be currently recognized and Treas. Reg. § 1.988-5(a)(6), which provides that upon "legging in" to an integrated transaction, exchange gain or loss is realized but deferred.

[33] Our analysis on this point is preliminary, and we would suggest that the issue be further considered either in the context of finalizing the proposed regulations regarding contingent debt or, alternatively, in the context of regulations regarding the Proposal.

6. A taxpayer who makes a constructive sale of a debt instrument with original issue discount or market discount should be treated as if the debt instrument were reacquired from someone other than the issuer.[34]

For example, suppose that the taxpayer owns a publicly-traded debt instrument with a basis and adjusted issue price of $600, a stated redemption price of $1000 and a value of $700. If the taxpayer makes a constructive sale of the debt instrument, proper adjustment should be made in the amount of original issue discount accruals subsequently required to be included by the taxpayer. The appropriate treatment would be to treat the instrument as reacquired with an acquisition premium of $100.

B. Nonmarketable Securities.

1. The Proposal provides that a contract to sell nonmarketable securities will not cause a constructive sale as long as an actual sale occurs within one year. The purpose of this one-year rule apparently is to allow time for parties to comply with commercially reasonable closing conditions, with the one-year limit being a proxy for commercial reasonableness.

[34] Cf. H. Rep. No. 103-11, 103d Cong., 1st Sess. (1993) (contract between dealer and related person treated as sold to person not related to dealer under Section 475 mark-to-market regime).

a. By its terms, the Proposal would appear to exempt only contracts to sell nonmarketable securities (and apparently contracts that create an option to sell nonmarketable securities, though this is less clear), but not swaps, short sales or other transactions that would otherwise produce a constructive sale. Limiting the one-year exception to sale contracts and options seems to us consistent with the policy objective set forth above in the preceding paragraph.

b. By its terms, the one-year exception would appear to exempt contracts to sell direct ownership of stock, debt or partnership interests, but not contracts to sell other positions in stock, debt or partnership interests. For example, if a taxpayer that directly owns stock of a closely held corporation enters into a contract to sell such stock, the one-year rule applies, but if a taxpayer owns a nonmarketable option to purchase closely held stock and enters into a contract to sell the option, the one-year rule apparently does not apply. We assume that this limitation reflects an intention to limit the one-year exception to the most typical commercial sales.

c. The Proposal requires that “the sale” occur within one year. If a hedge contemplates cash settlement, rather than an actual sale of the underlying nonmarketable securities, we assume that the one-year exception is not available.

d. If the sale is contemplated to occur within one year, but for reasons beyond the control of the parties (e.g., delay in obtaining regulatory approval) in fact occurs after one year, is the taxpayer retroactively treated as having constructively sold at the time of entering into the contract? Such treatment might raise the possibility of a substantial understatement penalty under Section 6662, which would generally seem an inappropriate result. A possible approach would be to find no constructive sale if the taxpayer can show a bona fide business reason for the delay and, in the absence of such a showing, to deem the sale to occur at the one-year anniversary.

e. How should taxpayers and the IRS value nonmarketable securities that have been constructively sold? Presumably, the determination would be made based on all the facts and circumstances, with predominant emphasis on the terms of the transaction that triggered the constructive sale.

f. There is some tension (though not, strictly speaking, a technical inconsistency) between the approach of the Proposal and the installment sale rule of Section 453 insofar as nonmarketable securities are concerned. The installment sale rule generally does not impose tax prior to the receipt of the sales price, except for the interest charge on the deferred tax imposed pursuant to Section 453A. Consideration might be given to treating constructive sales of nonmarketable securities as installment sales, although this may entail some complexity.

C. Sales Contracts Subject to Commercial Closing Conditions.

1. The Proposal is in tension with the well-settled rule that a sale is not consummated for tax purposes until closing. Clarification is needed on the interaction of these two principles.

   a. Suppose that a taxpayer owns 80% of the stock of a subsidiary and the public owns the other 20%. The taxpayer agrees on December 15 in Year 1 to sell the taxpayer's shares to a buyer subject to satisfaction of customary conditions, which all parties expect to be satisfied in the first few months of Year 2. Would the Proposal treat the taxpayer as constructively selling in Year 1? If so, how would the Proposal apply if in fact the sale did not occur?[35]

[35] As noted in Part V.B., above, similar concerns arise in the case of nonmarketable securities.

b. How would the Proposal apply to shareholders of a publicly-traded target corporation that entered into a taxable merger agreement with an acquiror subject to customary closing conditions that the parties expected to be satisfied? Since a constructive sale requires that the taxpayer "enters into" the offsetting position, it appears that shareholders of the target would generally not be treated as having constructively sold their stock (except perhaps holders of large blocks who actually bind themselves to participate in the merger).[36]

c. One possible approach is not to find a constructive sale as long as the taxpayer shows a genuine business purpose for the closing conditions, i.e., that they are commercially reasonable. A possible shortcoming of this approach, though, is that the genuineness of business purposes may be difficult to evaluate.

In distinguishing between meaningful and tax-motivated closing conditions, therefore, it may be preferable to rely on indicators that are objective. One possible indicator is the percentage of the company being purchased. If

[36] See Part VII.C., below, for a comment regarding contracts to enter into tax-free exchanges.

the entire company is purchased, the taxpayer is almost certainly engaged in a bona fide business transaction with closing conditions that should be respected. We therefore recommend that, in general, constructive sale treatment would not apply to contracts to sell at least a specified percentage (e.g., 20%) of a corporation or partnership (whether public or private).[37]

VI. Effect of a Constructive Sale.

A. Transactions Covering Less than All of Appreciated Financial Positions.

1. If a taxpayer constructively sells less than all the appreciated property it holds, the Proposal provides that this property is deemed sold "in the order in which acquired or entered into." Section 1259(d)(1). As a preliminary matter, the rationale for a mandatory FIFO rule is unclear. Where a taxpayer makes an actual sale of less than all the appreciated property it holds, it is permitted to identify the lot deemed sold. See Treas. Reg. § 1.1012-1(c). Why, then, should the rule be different merely because this sale is constructive? We recommend that taxpayers be entitled to identify, at the time of entering into a

[37] Application of this standard should focus on the total amount transferred to the buyer -- rather than on the amount any individual seller sells. For example, if ten shareholders each own 10% of the company, and two sell all their shares to the same buyer, the sale would qualify for our proposed exception, because the buyer purchased 20% of the company (even though no seller sold more than 10%).

transaction subject to the Proposal, the positions that are constructively sold. A FIFO rule would then apply only in the absence of such identification.

2. The FIFO rule gives no guidance for taxpayers who purchased separate lots of appreciated property at the same time. For example, suppose that a taxpayer purchases a share of stock and a call option on such stock on the same day. At a time when both positions have appreciated, the taxpayer enters into a short position with respect to the stock that substantially eliminates risk of loss and opportunity for gain in either, but not both, the long stock and call positions. How does the taxpayer determine which position is constructively sold? In our view, the hedge should be matched to the position it most closely resembles.

3. Suppose that a taxpayer and a related party each buy 100 shares of the same stock on the same day. Subsequently, the taxpayer shorts 100 shares; it would seem that the transaction should trigger a constructive sale of the taxpayer's own shares, rather than the shares owned by the related party. Suppose, however, that the related party purchased shares earlier. If the FIFO rule is applied without distinguishing shares held directly from shares held by a related party, the constructive sale would be of the related party's shares. This result highlights the importance of limiting the related-party rules to cases of intentional avoidance, as Section 1259(c)(4)(B) provides.

B. <u>Lapse, Termination or Disposition of a Hedge</u>.

1. It appears that gain recognized in a constructive sale of the underlying position is not taken into account in determining the amount of gain subsequently recognized on a cash-settled hedge.

   Suppose that a taxpayer that owns stock with a basis of $0 and a value of $100 enters into a cash-settled forward contract with respect to the stock for $105. Entering into the forward contract causes a constructive sale of the stock giving rise to gain recognition of $100. Suppose that at the time the forward contract terminates, the value of the stock is $90, so that the taxpayer receives $15 from the forward purchaser. The taxpayer’s overall position is $105 (equal to the $90 value of the stock that the taxpayer owns plus the $15 that the taxpayer receives). The taxpayer has invested $0, and arguably should therefore have overall gain of $105, of which $100 was recognized in the constructive sale. At the time the forward contract is closed, does the taxpayer include $15, the amount of gain under the forward contract, or $5, reflecting an adjustment for the gain previously recognized? It appears that the taxpayer would recognize $15, because the adjustment in Section 1259(a)(2)(A) applies to gain or loss subsequently realized with respect to the position constructively sold, not the hedge.

2. How does the Proposal apply if the taxpayer constructively sells an asset by entering into a transaction that contemplates an actual sale of the asset, but the actual sale never occurs?

   For example, suppose that the taxpayer owns stock with a basis of $0 and a value of $100 and, on June 1 of Year 1, purchases for $50 a deep in-the-money put that expires on June 1 of Year 4. If the put is substantially certain to be exercised, then the taxpayer recognizes $100 in Year 1 by reason of purchasing the put. If the put expires unexercised, because the value of the stock increased above the strike price, the taxpayer is entitled to a $50 loss (subject to limitation under Section 1092). The Proposal as drafted does not permit the taxpayer to reverse the $100 constructive sale gain by taking a loss of $100.

C. <u>Collateral Effects of Constructive Sale</u>.

1. Section 1259(a)(1) states that if a taxpayer constructively sells an appreciated financial position, the position “shall be treated as sold” and gain, if any, shall be taken into account. It should be clarified whether sale treatment applies for purposes of the Code other than gain recognition.

Specifically, if a taxpayer enters into a hedge that triggers a constructive sale, would this constructive sale be a sale for purposes of determining whether (a) there is continuity of proprietary interest in a reorganization, (b) a shareholder corporation would be permitted to continue filing a consolidated return with a subsidiary whose stock was constructively sold, (c) an ownership change has occurred under Section 382 and (d) the five-year tests of Section 355(d)(3) and the device test of Section 355(a)(1)(B) are met?

In the interest of administrative simplicity, it might be tempting to regard constructive sales as sales for all purposes, rather than for the purpose of gain recognition alone. However, we urge caution in expanding the Proposal's reach beyond the area (and the perceived abuse) that inspired it, i.e., gain recognition. Whether constructive sale treatment should apply in other areas should in our view depend upon whether such treatment would advance the policies served by these other areas -- a question not readily resolved without careful study. Perhaps such an inquiry could be conducted effectively during promulgation of regulations (which we believe should apply prospectively). We recommend, therefore, that the Proposal by its terms should only provide for gain recognition, leaving collateral consequences to be determined on a case by case basis.

2. Under Section 1259(a)(2)(B), the holding period of the appreciated financial position for periods following the constructive sale is determined as if the position were originally acquired on the date of the constructive sale. Consistent with our suggestion in 1., above, we believe that the holding period rule should be confined to the issue of gain and loss on the appreciated financial position, so that this rule would not apply for purposes of, for example, Section 246(c). Thus, a taxpayer that already has satisfied the Section 246(c) holding period will not be required after the constructive sale to establish a new 46-day (or 91-day) holding period.[38]

3. The Proposal does not appear to treat the appreciated financial position and the offsetting positions as an integrated instrument after the constructive sale. For example, if a taxpayer owns a share of publicly-traded stock with a basis of $0 and a value of $100 and enters into a forward contract to sell the stock in two years for $120, the Proposal would require the taxpayer to recognize $100 on the date that the taxpayer enters into the forward contract. Apparently, the Proposal would not require the taxpayer to accrue $20 of original issue discount over the two-year period. Cf. Section 1258 (ordinary income on disposition or termination of conversion transaction position).

[38] Any abuse that arises from claiming the dividends received deduction with respect to dividends received while the taxpayer is subject to an obligation to pay over dividend-equivalent amounts either by virtue of a short sale or a "total return" equity swap would appear to be dealt with by current Section 246(c)(1)(B).

VII. Special Rules.

A. We are puzzled by Section 1259(d)(3), which provides that "for purposes of this provision, an interest in a trust that is actively traded (within the meaning of section 1092(d)(1)) shall be treated as stock." If a trust is treated as a partnership or corporation for tax purposes, it would appear that interests in the trust would already be covered. If the trust is treated as a grantor trust, we see no particular reason why the applicability of the Proposal to interests in the assets of the trust requires a special rule. Absent a special rule, we would interpret the Proposal to apply to hedges with respect to beneficial interests in trust assets consisting of stock, debt, or partnership interests, but not, for example, to beneficial interests in trust assets consisting of real estate or interests in commodities.

B. It would seem appropriate to exempt stock in a housing cooperative from the provisions of the Proposal, since real estate assets are not generally subject to the Proposal. Cf. Section 163(h)(4)(B) (owners of cooperative stock entitled to deduct mortgage interest).

C. We note that a taxpayer who contributes appreciated property to a partnership or corporation in exchange for, say, a 2% stock or partnership interest may (as a result of diversification) eliminate substantially all of the taxpayer's economic risk of loss or opportunity for gain with respect to the contributed stock. The Proposal would appear to be inapplicable in this context because the taxpayer does not acquire an offsetting position with respect to the same or substantially identical property; rather, the elimination of risk depends precisely on the fact that the stock or partnership interest received upon the exchange is not substantially identical to the contributed appreciated property. We believe that this result is appropriate. The “investment company” rules under Section 351 and the analogous principles under Section 721 already address the abuse, if any, involved in such a transaction. Any concern regarding the adequacy of the existing rules should be considered in the context of Sections 351 and 721, rather than by means of the Proposal.

In addition we do not believe that the Proposal is intended to treat as a constructive sale an exchange pursuant to a tax-free reorganization, or the entry into a contract to make such an exchange. Indeed, even if the contract for such a tax-free exchange entitles the target shareholder to a fixed dollar amount of the acquiror's stock at closing, the Proposal should not apply.

<u>Exhibit A</u>

DESCRIPTION OF TAX PROVISIONS INCLUDED IN A PLAN TO ACHIEVE A BALANCED BUDGET SUBMITTED TO THE CONGRESS BY THE PRESIDENT ON JANUARY 6, 1996

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

January 24, 1996
JCX-1-96

10. Constructive sales treatment for appreciated financial positions

Present Law

In general, gain is realized when a taxpayer disposes of property in exchange for money or other property Gain is determined by comparing the amount realized with the adjusted basis of the particular property sold In the case of corporate stock, the basis of shares purchased at different dates or different prices is determined by reference to the actual lot sold if it can be identified, and if identification cannot be made, then by reference to the basis of the earliest of the lots purchased Certain securities held by dealers, and certain financial contracts are “marked-to-market” and gain on these instruments is recognized as it accrues.

In the case of a short sale, i.e., a sale of property which the taxpayer does not own. the sale is deemed consummated at the time of delivery of the property to close the short sale If a taxpayer sells short property at the time it owns substantially identical appreciated property, (a “short sale against the box”), the form of the transaction is respected for income tax purposes and gain on the substantially identical property is not recognized at the time of the short sale Present law does provide rules to prevent the conversion of short-term capital gain into long-term capital gain where there is a short sale against the box.

Taxpayers may engage in other arrangements, such as “equity swaps” and “notional principal contracts” and options, where the risk of loss and opportunity for gain are shifted to another party (the “counterparty”). These arrangements do not result in the recognition of gain by the taxpayer.

Description of Proposal

Certain transactions in appreciated financial positions would be treated as constructive sales. Gain (but not loss) would be recognized at the time of the transaction as if the property were sold for fair market value at the date of the constructive sale. Proper adjustment would be made in the amount of any gain or loss subsequently realized; and the new holding period of such position would be determined as if such position were originally acquired on the date of the constructive sale.

An appreciated financial position would be defined as any position with respect to any stock, debt instrument partnership interest, or certain actively traded trust instruments, if there would be gain were the position sold A position would be defined as any interest, including a futures or forward contract, short sale, or option.

A constructive sale of such a position would occur if the taxpayer or a related person (as defined by reference to certain circumstances) enters into one or more positions with respect to the same or substantially identical property which, for some period, substantially eliminates both risk of loss and opportunity for gain on the appreciated financial position; or enters into any other transaction which is marketed or sold as being economically equivalent to any such transaction A constructive sale would include making a short sale with respect to substantially identical property, the granting of a call option, or the acquisition of a put option with respect to the same or substantially identical property, but only if there is a substantial certainty that such call or put option will be exercised.

Constructive sales would not include any transaction if the appreciated financial position which is part of such transaction is marked to market under present law section 475 (mark to market for securities dealers) or section 1256 (mark to market for futures contracts, options and currency contracts).

A constructive sale also would not include any contract for the sale of any stock, debt instrument, or partnership interest which is not a marketable security (as defined in the section 453(f) rules that apply to installment sales) if the sale occurs within one year after the date such contract is entered into.

A person would be considered related to another for purposes of the proposal if the relationship would result in a disallowance of losses under sections 267 or 707(b) and the transaction is entered into with a view toward avoiding the purposes of the provision.

In the case of a constructive sale of less than all of the appreciated financial positions held by the taxpayer, the provision would apply to such positions in the order in which acquired or entered into.

If there is a constructive sale of any appreciated financial position which is subsequently sold or disposed of while the constructive sale transaction remains open, then solely for purposes of determining whether the taxpayer has entered into a constructive sale of any other appreciated financial position held by the taxpayer, such transaction shall be treated as entered immediately after the sale or disposition.

Effective Date

The proposal would be effective for constructive sales entered into after the date of enactment It would also apply to constructive sales entered into after January 12, 1996 and before the date of enactment that are not closed before the date which is 30 days after the date of enactment, the proposal would apply to such transactions as if the constructive sale occurred on the date which is 30 days after the date of enactment.

In the case of a decedent dying after the date of enactment, if a constructive sale of an appreciated financial position had occurred before the date of enactment and was open on the day before the decedent's death, such position (and any property related to it. under principles of the provision) would be treated as property constituting rights to receive income in respect of a decedent.

<u>Exhibit B</u>

TAXATION, BUDGET AND ACCOUNTING TEXT

LEGISLATIVE LANGUAGE OF REVENUE AND BUDGET ENFORCEMENT TITLES OF PRESIDENT CLINTON'S SEVEN-YEAR BALANCED BUDGET PLAN, PRESENTED TO CONGRESS JAN.9, 1996

(TEXT)

(Editor's Note: This language does not reflect changes to the president's budget budget plan subsequently made by the administration in closed door meetings with congressional leaders Jan. 9.)

TITLE IX-LIMITATIONS ON CORPORATE

WELFARE AND OTHER REVENUE PROVISIONS

SEC. ___ 001. AMENDMENT OF 1006 CODE.

Except as otherwise expressly provided, whenever in this title an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to such section or other provision of the Internal Revenue Code of 1986.

SEC. ___ 002. TABLE OF CONTENTS.

The table of contents for this title is as follows:

TITLE ___ LIMITATIONS ON CORPORATE WELFARE AND OTHER

REVENUE PROVISIONS

Sec. ___ 001. Amendment of 1986 Code.
Sec. ___ 002. Table of contents.

Subtitle A – Expatriation

Sec. ___ 101. Revision of tax rules on expatriation.
Sec. ___ 102. Information on individuals expatriation.

Subtitle B – Corporate Reforms

Sec. ___ 201. Tax treatment of certain extraordinary dividends.
Sec. ___ 202. Representation of confidential corporate tax abettors.
Sec. ___ 203. Dental of deduction for interest on losses with respect to company-owned insurance.
Sec. ___ 204. Termination of supposes accounts for family operations required to use actual method of accounting.
Sec. ___ 205. Modification of Puerto Rice and premium tax credit.
Sec. ___ 206. Personal property used predominately in the United States treated as not property of a like and with report to property used predominately outside the United States.
Sec. ___ 207. Repeal of financial institute transaction rule to install allocation rules.
Sec. ___ 208. Conversion of large operations the 8 corporations treated as complete abjuration.
Sec. ___ 209. Modification of taxable years to which not expiating losses may be carried.
Sec. ___ 210. Constructive sales treatment for appreciated financial passions.
Sec. ___ 211. Modification of rules for allocating interest exposes to tax exempt interest.

Sec. ___ 212. Reduction of 70 present dividends received deduction to §0 present.

Sec. ___ 213. Modification of holding period applicable to dividends received deduction.

Sec. ___ 214. Certain preferred states treated as best.

Sec. ___ 215. Dental of interest deductions on certain debs instruments.

Sec. ___ 216. Deferral of deduction for interest on convertible debt until payment.

Subtitle C – Foreign Provisions

PART I – Foxes Trusts

Sec. ___ 301. Improved information reporting on foreign trusts.

Sec. ___ 302. Modifications of rules relating to foreign trusts having one of more United States beneficial.

Sec. ___ 303. Foreign persons not to be treated as centers under granter trust rules.

Sec. ___ 304. Information reporting regarding foreign gifts.

Sec. ___ 305. Modification of rules relating to foreign trusts which are not granter trusts.

Sec. ___ 306. Residence of estates and trusts, etc.

PART II – OTHER FOREIGN PROVISIONS

Sec. ___ 311. Definition of foreign personal holding company income.

Sec. ___ 312. Treatment of foreign and gas extraction income.

Sec. ___ 313. Limitation on exclusion of earned income of cousins or residents of the United States Living abroad.

Subtitle D – Accounting Provisions

Sec. ___ 401. Repeal of bad debt reserve method for thrift savings associations.
Sec. ___ 402. Depreciation under income forecast method.
Sec. ___ 403. Repeal of lower-of-one-or-market method of accounting for inventories.

Subtitle E – Administrative Provisions

Sec. ___ 501. Repeal of diesel fuel tax rotate to purchasers of diesel-powered auto-mobiles and light trucks.
Sec. ___ 502. Increased information reporting penalties.

Subtitle F – Casualty and Involuntary Conversion Provisions

Sec. ___ 001. Repeal of diesel fuel tax rotate to purchasers of diesel-powered auto-mobiles and light trucks.

Subpart G – Excuse Tax an Amounts of Private Estates Benefits

Sec. ___ 701. Excuse taxes for failure by certain charitable originations to more certain qualification requirements.
Sec. ___ 702. Reporting of certain access taxes and other information.
Sec. ___ 703. Increases in penalties on exempt organizations for failure to file open plate and timely annual returns.

Subtitle H – Extension of Certain Taxes

Sec. ___ 801. Extension of hazardous substances Superfund taxes.
Sec. ___ 802. Extension of spell liability tax.
Sec. ___ 803. Extension of Federal unemployment tax.

Subtitle I – Provisions Relating To Individuals

Subtitle J – Reform of Earned Income Credit

Subtitle A – Expatriation

SEC. ___ 101. REVISION OF TAX RULES ON EXPATRIATION.

(a) IN GENERAL. – Subpart A of part II of subchapter N of chapter 1 is amended by inserting after section 877 the following new section:

SEC. 877A. TAX RESPONSIBILITIES OF EXPATRIATION.

“(a) GENERAL RULES. – For purposes of this subtitle-

“(1) MARK TO MARKET. – Except as provided in subsection (f), all property of a covered expatriate to which this section applies shall be treated as sold on the expatriation date for its fair market value.

“(2) RECOGNITION OF GAIN OR LOSS. – In the case of any sale under paragraph (1)-

“(A) notwithstanding any other provision of this title, any gain arising from such shall be taken into account for the taxable year of the sale unless such gain is excluded from gross income under part III of subchapter B. and

“(B) any loss arising from such sale shall be taken into account for the taxable year of the sale to the extent otherwise provided by this title, except that section 1091 shall not apply (an section 1092 shall apply) to any such loss.

“(3) EXCLUSION FOR CERTAIN GAIN. – The amount which would (but for this paragraph) be includible in the gross income of any individual by reason of this section shall be re-

SEC. ___ 210. CONSTRUCTIVE SALES TREATMENT FOR APPRECIATED FINANCIAL POSITIONS.

(a) IN GENERAL. – Part IV of subchapter P of chapter 1 is amended by adding at the end the following new section:

“SEC. 1960. CONSTRUCTIVE SALES TREATMENT FOR APPRECIATED FINANCIAL POSITIONS.

“(a) IN GENERAL. – If there is a constructive sale of an appreciated financial position-

“(1) such position shall be treated as sold for its fair market value on the date of such constructive sale (and any gain shall be taken into account for the taxable year which includes such date, and

“(2) for purposes of applying this title for periods after the constructive sale-

“(A) proper adjustment shall be made in the amount of any gain or loss subsequently realized with respect to such position for any gain taken into account by reason of paragraph (1), and

“(B) the holding period of such position shall be determined as if such position were originally acquired on the date of such constructive sale.

“(b) APPRECIATED FINANCIAL POSITION. – For purposes of this section-

“(1) IN GENERAL. – The term 'appreciated financial position' means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold.

“(2) POSITION. – The term 'position' means an interest, including a futures or forward contract, short sale, or option.

“(c) CONSTRUCTIVE SALE. – For purposes of this section-

“(1) IN GENERAL. – A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer or a related person-

“(A) enters into 1 or more positions with respect to the same or substantially identical property which, for some period, substantially eliminate both risk of loss and opportunity for gain on the appreciated financial position, or

“(B) enters into any other transaction which is marketed or sold as being economically equivalent to any transaction described in subparagraph (A).

The transactions described in subparagraph (A) shall include making a short sale with respect to substantially identical property, and the granting of a call option, or the acquisition of a put option, with respect to the same or substantially identical property but only if there is a substantial certainly that such call or put option will be exercised.

“(2) EXCEPTION FOR TRANSACTIONS MARKET TO MARKET. – The term 'constructive sale' shall not include any transaction if the appreciated financial position which is part of such transaction is marked to market under section 475 or 1256.

“(3) EXCEPTION FOR SALES OF NON-PUBLICITY TRADED PROPERTY. – The term 'constructive sale' shall not include any contract for sale of any stock, debt instrument, or partnership interest which is not a marketable security (as defined in section 453(f)) if the sale occurs within 1 year after the date such contract is entered into.

“(4) RELATED PERSON.- A person is related to another person with respect to a transaction if-

“(A) the relationship between such persons would result in a disallowance of losses under section 267 or 707 (b), and

“(B) such transaction is entered into with a view toward avoiding the purposes of this section.

“(d) SPECIAL RULES. -

“(1) TRANSACTIONS COVERING LESS THAN ALL OF APPRECIATED FINANCIAL POSITIONS. – If there is a constructive sale of loss than all of the appreciated financial positions held by the taxpayer, subsection (a) shall apply to such positions in the order in which acquired or entered into.

“(2) TREATMENT OF SUBSEQUENT SALE OF POSITION WHICH WAS DEEMED SOLD. – If –

“(A) there is a constructive sale of any appreciated financial position.

“(B) such position is subsequently sold or otherwise disposed of, and

“(C) at the time of such sale or disposition, the transaction resulting in the constructive sale of such position is open,

solely for purposes of determining whether the taxpayer has entered into a constructive sale of any other appreciated financial position held by the taxpayer, the taxpayer shall be treated as entering into such transaction immediately after such sale or other disposition.

"(3) CERTAIN TRUST INSTRUMENTS TREATED AS STOCK. – For purposes of this section, an interest in a trust which is actively traded (within the meaning of section 1092(dx1)) shall be treated as stock.

"(e) REGULATIONS. – The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section."

(b) CLERICAL AMENDMENT. – The table of sections for such part IV is amended by adding at the end the following new item:

"Sec 1259 Constructive sales treatment for appreciated financial positions."

(c) EFFECTIVE DATE. -

(1) IN GENERAL. – The amendments made by this section shall apply to-

(A) constructive sales after the date of the enactment of this Act, and

(B) constructive sales after January 4, 1996, and before the date of the enactment of this Act but only if the transaction is not closed before the date which is 30 days after the of the enactment of this Act.

In a case to which subparagraph (B) applies, section 1259 of the Internal Revenue Code of 1986 (as added by this section) shall be applied as if the constructive sale occurred on the date which is 30 days after the date of the enactment of this act.

(2) SPECIAL RULE. – In the case of a decedent dying after the date of the enactment of this Act, it-

(A) there was a constructive sale on or before such date of enactment of any appreciated financial position, and

(B) on the day before the date of the decedent's death, the transaction resulting in the constructive sale of such position is open,

for purposes of the Internal Revenue Code of 1986, such position (and any property related thereto, as determined under the principles of section 1259(d)(1) of such Code (as so added)) shall be treated as property constituting rights to receive an item of income in respect of a decedent under section 691 of such Code.

Exhibit C

DEPARTMENT OF THE TREASURY

TREASURY NEWS

OFFICE OF PUBLIC AFFAIRS · 1500 PENNSYLVANIA AVENUE, N.W. · WASHINGTON, D.C. · 20220 · (202) 622-2960

Embargoed Until 4 PM (ET)
January 12, 1996

Contact: Calvin Mitchell
(202) 622-2920

TREASURY COMMENTS ON "SHORT AGAINST THE BOX" PROPOSAL

Proposals regarding "short against the box" and other similar transactions are being considered as part of the ongoing budget negotiations. Today, Treasury provided a description of one such proposal. The provision, which was included in one of the budget packages under discussion, is aimed at tax-deferral techniques community referred to as "short against the box" transactions and other transactions, such as "equity swaps," that accomplish comparable results.

DESCRIPTION

The proposal would require a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in either stock, a debt instrument, or a partnership interest. A taxpayer would be treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain limited circumstances, a person related to the taxpayer) substantially eliminates risk of loss and opportunity for gain by entering into one of more positions with respect to the same or substantially identical property. For example, a taxpayer that holds appreciated stock and enters into a short sale with respect to that stock (a short against the box) or an equity swap with regard to the stock would recognize any gain on the stock. Similarly, a taxpayer that holds appreciated stock and grants a call or centers into a put option on the stock would generally recognize gain on the stock if there is a substantial certainty that the option will be exercised. In addition, a taxpayer would recognize gain on an appreciated position in stock, debt or partnership interest if the taxpayer entered into a transaction that is marketed or sold as substantially eliminating the risk of loss and opportunity for gain.

The taxpayer would recognize gain in a constructive sale as if the position were sold and immediately repurchased. An appropriate adjustment (such as an increase in the basis of the position) would be made for gain recognized on the constructive sale, and a new holding period would begin as if the taxpayer had acquired the position on the date of the constructive sale.

If the taxpayer makes a constructive sale of less than all of his or her appreciated positions in a particular property, the proposal would trigger gain recognition in the order the positions were acquired or entered into. If the taxpayer actually disposed of a position previously constructively sold, the offsetting positions creating the constructive sale still held by the taxpayer would be treated as causing a new constructive sale of appreciated positions in substantially identical property, if any, the taxpayer holds at that time.

The proposal would not apply to any contact for the sale of any stock, debt instrument or partnership interest that is not a marketable security (as defined under the rules that apply to installment sales) if the sale occurs within one year of the date the contract is entered into. In addition, the proposal would not treat a transaction as a constructive sale if the taxpayer is required to mark to market the appreciated financial position under section 475 (mark to market for securities dealers) or section 1256 (mark to market for futures contracts, option and currency contracts.)

The proposal would be effective for constructive sales entered into after the proposal is enacted. In addition, the proposal would apply to constructive sales entered into after January 12, 1996, and before the date of enactment that are not closed before 30 days after the date of enactment; the proposal would apply to such transactions as if the constructive sales occurred on the date that is 30 days after the date of enactment.

A special rule is included for constructive sales entered into on or before the date of enactment by decedents dying after the date of enactment, If the constructive sale remains open on the day before date of death and gain has not been recognized under this provision, the positions constituting the constructive sale are treated as property constituting right to receive income in respect of a decedent under section 691.