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January 6, 1986

J. Roger Mentz, Esq.
Acting Assistant Secretary
United States Treasury
15th & Pennsylvania, N.W.
Room 3108
Washington, D.C. 20220

Dear Roger:

Enclosed is the report of the Committee on Commodities and Financial Futures regarding temporary and proposed regulations applying short sale and wash sale principles under section 1092. The report recommends a revised definition of "successor positions" and makes numerous technical comments on the specific examples contained in the regulations. The report also discusses the effect of the regulations on the "married put rule" of section 1233(c). It recommends that consideration be given to perspective application of the regulations to situations previously governed by section 1233(c).

Sincerely yours,

Dale S. Collinson

DSC:bd
Enclosure

cc: Mikel M. Rollyson) w/attachment
Linda Carlisle)

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REPORT #513

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January 6, 1986

Commissioner Roscoe L. Egger, Jr.
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Egger:

Enclosed is the report of the Committee on Commodities and Financial Futures regarding temporary and proposed regulations applying short sale and wash sale principles under section 1092. The report recommends a revised definition of "successor positions" and makes numerous technical comments on the specific examples contained in the regulations. The report also discusses the effect of the regulations on the "married put rule" of section 1233(c). It recommends that consideration be given to perspective application of the regulations to situations previously governed by section 1233(c).

Sincerely yours,

Dale S. Collinson

Dale S. Collinson

DSC:bd
Enclosure

cc: Timothy McKenna) w/attachments
John M. Fischer)

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REPORT #513

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Committee on Commodities and Financial Futures

Report on the Proposed and Temporary Regulations under Section 1092

January 6, 1986

This Report[1] discusses the Treasury Regulations[2] recently issued under Code section 1092.[3] The Regulations deal with the application of short sale and wash sale principles to straddles and implement two special taxpayer elections with respect to straddles that include regulated futures or other section 1256 contracts, the "identified mixed straddle" and the "mixed straddle account" elections. The Regulations were published on January 24, 1985.[4]

I. Background to the Regulations

In the 1970s, increasing numbers of taxpayers attempted to avoid tax through the use of commodity straddles.[5] A "straddle" is formed by holding simultaneously two or more offsetting investment positions. A typical

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1 This report was prepared by Eric J. Anderson with the assistance of Sherry V. Hyatt. Helpful comments were received from Dale S. Collinson, Donald Schapiro, Edward D. Kleinbard, James M. Peaslee, Greer L. Phillips, Michelle P. Scott, and Joel D. Zychick.

2 Prop. and Temp. Treas. Reg. §§1.1092(b)-1T, 1.1092(b)-2T, 1.1092(b)-3T, 1.1092(b)-4T and 1.1092(b)-5T; hereinafter cited by section number or referred to as the "Regulations."

3 Throughout this report, references to the "Code" are to the Internal Revenue Code of 1954, as amended.

4 50 Fed. Reg. 3317. Corrections to typographical errors in the regulations were published on March 28, 1985, 50 Fed. Reg. 12243, and May 8, 1985, 50 Fed. Reg. 19343.

5 See, e.g., S. Rep. No. 144, 97th Cong., 1st Sess. (hereinafter referred to as "Senate Report, 1981 Act") 145-146 (1981).

commodities futures straddle consists of a long futures position in a commodity (say, a contract to buy gold for delivery in July of 1986) coupled with a short futures position in the same commodity, for delivery in a neighboring month (say, a contract to sell gold for delivery in August of 1986). Fluctuations in the price of the underlying commodity (or in carrying costs or interest rates) will result in gains on one position (or "leg") of the straddle which are largely or completely offset by corresponding losses in the other leg of the straddle. Straddles are thus used to hedge the risk of loss inherent in a single investment position. Because of the extreme volatility of commodity prices, and because of the liquidity of the commodity futures market, substantial fluctuations in the price of each leg can occur within a few days.[6] The net overall gain or loss to the holder of a straddle (which results when the prices of the offsetting positions do not move equally in opposite directions), while potentially considerable, is therefore small compared to the magnitude of the fluctuations in the absolute price levels of the two positions.

Prior to the Economic Recovery Tax Act of 1981 (the "1981 Act"), recognition of gain or loss for tax purposes on a commodity futures position did not occur until the position was

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[6] See, e.g., Rev. Rul. 77-185, 1977-1 C.B. 49.

formally closed out on a futures exchange, normally by opening a directly offsetting position in the same delivery month (which would then be netted out by the exchange). By contrast, the acquisition of an offsetting position for delivery in a neighboring month was viewed as a separate investment,[7] and did not cause recognition treatment. As a result, a taxpayer could enter into a straddle, wait for a price shift, and choose to recognize loss on one leg by closing out that position, while postponing the gain on the leg that had increased in value. The taxpayer could then replace the loss leg on the next day with a new position in the same commodity in a neighboring month, thus maintaining the protection of a balanced straddle, but recognizing a loss matched economically by unrecognized gain. The loss would not be disallowed by the wash sale provisions of Code section 1091, since that section did not apply to commodity futures contracts.[8] In some

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[7] See Code section 1233(e)(2)(B) (futures requiring delivery in different calendar months are not "substantially identical" property for purposes of the short sale rules). Cf. Treas. Reg. §1.1233-1(d)(2) (circumstances under which futures for the same delivery month in different commodities or traded on different exchanges may be substantially identical).

[8] See Rev. Rul. 71-568, 1971-2 C.B. 312 (commodity futures contracts are not stock or securities and, therefore, the section 1091 wash sale provisions do not apply to losses from the sale of such contracts). The Internal Revenue Service took the position that the same result as if section 1091 had applied could be reached pursuant to Code section 165, Rev. Rul. 77-185, supra note 5; Rev.
(Footnote Continued)

cases, taxpayers could also claim that the gain leg resulted in long-term capital gain, but that the substantially equal losses were short-term capital losses.[9]

The 1981 Act took two separate approaches to the problem of straddles. First, Code section 1256 imposed an automatic, simple recognition rule for a broad class of futures

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(Footnote Continued)

[8] Rul. 78-414, 1978-2 C.B. 214, but taxpayers continued to challenge the Service's interpretation, see, e.g., Smith v. Commissioner, 78 T.C. 350 (1982).

[9] The recognition of short-term loss coupled with long-term gain was limited to the case where the gain leg of the straddle was a long position in a commodity. This result stemmed from a curious asymmetry in the provisions of section 1233. Under that section as applied to commodity futures, the "short sale" consisted of a short futures contract, and the delivery of "property" consisted of offset by entering into a corresponding long futures contract. Therefore, a "short sale of a commodity future" generated short-term capital gain whenever another futures contract was used to "close" the short future, regardless of the holding period of the short position. Therefore, gain on an exchange-traded short contract was always short-term. Gain on a long contract, however, could be long-term if held for more than six months. (Code section 1222, last sentence.) The concept of using a long future to "close" a short future -- that is, restricting short sale treatment to short positions -- persisted into the early drafts of the 1981 straddle legislation. See Senate Report, 1981 Act at 149. It is now clear that a position in personal property (such as a forward currency contract) can by itself generate capital gain or loss, and that long- or short-term treatment is generally determined by reference to the holding period of the interest itself rather than of any underlying property. See Code section 1234A; Senate Report, 1981 Act at 170 (gain or loss on such positions is "long-term when the holding period requirements are met"). Thus the anomalous effect of Code section 1233 -- no long-term gain on a short position -- does not apply to positions that are not commodity futures contracts.

contracts: recognition of all unrealized gain or loss at the end of the taxable year, based on the year-end market value.[10] This "mark-to-market" system required a modification to the holding period requirement for long-term capital gain treatment on futures contracts held as capital assets. The draftsmen chose an automatic "60/40" rule: mark-to-market gain or loss is capital and is 60% long-term and 40% short-term, regardless of the actual holding period.

The second approach was intended to eliminate tax avoidance opportunities for instruments that were not subject to the mark-to-market system. New Code section 1092(a)

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[10] The futures contracts subjected to this rule were "regulated futures contracts", defined generally to include contracts on domestic exchanges regulated by the Commodity Futures Trading Commission. Such exchange-traded contracts typically require daily posting of additional margin in the event of adverse price fluctuations (and conversely permit daily withdrawals of unrealized gains). In the case of straddles, additional deposits on the loss leg may be offset by withdrawals on the gain leg. This characteristic of daily margin initially suggested the "mark-to-market" treatment for tax purposes. Section 1256 treats each regulated futures contract on hand at the end of the taxable year as if it had been sold at year end (closed out through the exchange) at its fair market value. Any resulting gain or loss is recognized in that year regardless of the taxpayer's method of accounting. The class of instruments subject to this treatment was subsequently expanded by section 105(c) of the Technical Corrections Act of 1982 (the "1982 Act") to include interbank foreign currency forward contracts, and by section 102(a) of the Tax Reform Act of 1984 (the "1984 Act") to include exchange-traded options on commodities (including options on futures contracts in commodities), and on certain debt and equity instruments.

provided that, in general, a loss on one leg of a straddle would be deferred to the extent of unrecognized gain on another leg.[11] The 1981 Act also contemplated that short sale and wash sale "principles" would be extended to straddles. Recognizing, however, the considerable technical problems in drafting appropriate extensions of the short sale and wash sale provisions, Congress elected to leave implementation of those principles to regulations.[12] It was anticipated that the regulations, when adopted, could generally be made retroactive.[13]

The regulations had not appeared by 1984. In the 1984 Act, Congress gave the Treasury additional authority to draft provisions relating to "mixed" straddles (straddles where at least one, but not all, positions are "60/40" contracts),[14]

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[11] Code section 1092(a), as amended by the 1982 Act. The term "straddle" was defined to mean "offsetting positions" in actively-traded personal property; positions were offsetting if a "substantial diminution of the taxpayer's risk of loss" from holding one position resulted from his holding one or more other positions, section 1092(c) and (d). As pointed out below, these basic definitions have not yet been interpreted by regulations. Cf. section 1092(c)(3) (list of offsetting positions).

[12] Code section 1092(b)(1).

[13] Senate Report, 1981 Act at 149.

[14] Code section 1092(b)(2). The definition is that given by the Regulations, section 1.1092(b)-5T(e). Although Congress plainly left room for a broader definition of a "mixed" straddle, see section 1256(d)(4), the Regulations decline to take the opportunity.

and added a statutory provision mandating the production of the "initial" 1981 Act regulations within six months of the date of enactment of the 1984 Act.[15] The Regulations duly appeared on January 18, 1985. Although apparently produced under extreme time pressure, the Regulations generally work well to provide a comprehensive and logical system of short sale and wash sale rules, and to implement the new mixed straddle provisions. However, in some instances we think the Regulations (and particularly the examples) need revision, and in other instances amplification and clarification, to reflect the proper application of the principles involved.

II. General Comments

The Regulations cover four basic areas: wash sale rules, holding period (short sale) considerations, identified mixed straddles, and mixed straddle accounts.[16] Each of these areas will be discussed in turn. In addition, the report will examine the relationship of the Regulations to the "married put" rule of section 1233(c). This portion of the report makes a few overall comments on the Regulations.

First, and most important, the legislatively-imposed deadline has resulted in regulations that deal with only a narrow part of a complex and difficult statute. As a result,

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[15] Section 102(a), 1984 Act. The 1984 Act, P.L. 98-369, was enacted on July 18, 1984.

[16] See footnote 2.

the examples in the Regulations frequently take implicit positions as to the interpretation of broader issues. Some of the positions implicitly taken in the Regulations are controversial and, possibly, not fully considered. Consider the following example. The definition of an "offsetting position", while fundamental to the operation of the straddle provisions, is left to future regulations. In developing the role of multiple mixed straddle accounts, however, the Regulations at one point needed an example of a position that is "offsetting" to three separate accounts. The example chosen was an option on a broad-based stock index on one side, and three individual stocks on the other.[17] The example can be interpreted (unfortunately, in our view) as setting forth the Service's view that an option on a broad-based stock index future could "offset" three individual stocks, thus triggering the various loss deferral and holding period rules. While we understand that this particular example will be amended to remove this implication, it illustrates a phenomenon which will be noted frequently by this Report.

Second, the examples should conform to economic realities. For example, Example (11) of section 1.1092(b)-1T(f) discusses the circumstance of simultaneous unrecognized gain in each of two offsetting positions. It

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[17] See the example following section 1.1092-4T(b)(3).

hypothesizes a long and a short position that on November 15 have no implicit gain or loss, and that by year end each carries $18 of unrecognized gain. By contrast, the entire (one-sided) recognized loss against which loss deferral is to be applied is only $20. This is unrealistic except possibly in the case of very large positions. While it is perfectly valid to adopt a definition of "offsetting position" pursuant to which opposite positions may occasionally move in tandem,[18] and while the wash sale straddle rules are generally to be applied without regard to the magnitude of price differentials,[19] Congress intended that long positions generally offset short ones only to the extent they are balanced.[20] Therefore, an effort should be made to keep the price fluctuations less dramatic. The point is particularly important in the context of the implicit assumption in the Regulations that -- for purposes of the examples, at least -- "long" positions are automatically offsetting to "short"

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[18] See Code section 1092(c)(3), last sentence (positions shall be presumed to be offsetting only if their values "ordinarily" vary inversely).

[19] Cf. the comments on section 1.1092(b)-1T(f), Example (16), p. 27 below.

[20] Staff of the Joint Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981 (Comm. Print 1981) (hereinafter referred to as "General Explanation, 1981 Act") at 288.

positions.[21]

III. Wash Sales

A. In general

Code section 1092(b)(1) exhorts the Secretary to produce regulations applying the "principles" of the wash sale provisions to positions in personal property. Section 1.1092(b)-1T of the Regulations implements these rules. This section of the Report comments on those provisions.

The precedent, Code section 1091, has been firmly established in the tax law since before the 1939 Code.[22] Assume investor A buys XYZ stock; the price of XYZ stock falls; A sells the XYZ stock at a loss; and the next day A repurchases the same quantity of XYZ stock. Section 1091 provides that A must postpone his loss (and substitute the cost of the stock sold as the basis of his new XYZ stock). The section was enacted, in part, to avoid the disruption of the markets by tax-motivated sales and repurchases of securities.[23]

The purpose of the personal property analogue -- the subject of the instant regulations -- is quite different. It is plain that if, instead of XYZ stock, A buys, sells and

[21] Compare section 1.1092(b)-1T(f), Example (10), where for wash sale purposes overlapping short contracts can both offset the same long contract.

[22] Sections 214 and 234 of the Revenue Act of 1921.

[23] Remarks of Mr. Reed, 65 Cong. Rec. 7604 (1923) ("the stock market thrown into a state of mild convulsions").

immediately repurchases gold, his loss is recognized, even though gold is actively traded personal property.[24] Instead, the wash sale rule for commodities straddles is intended to plug a potential hole in the operation of the section 1092 loss deferral rule. In the classic example, investor B goes long August silver and short September silver; the price of silver rises; B closes out his short (loss) leg and recognizes the loss; B reestablishes the short position the next day. So far this is the standard loss deferral situation: if the market stays constant to year end, B will have unrecognized gain in his long leg that will cause the recognized loss in the short leg to be deferred. Now suppose that the market does not stay constant, but instead, returns to its original level. The long leg -- the leg that is held throughout -- now has no unrecognized gain; the loss on the first short leg has still been realized; but now the corresponding unrecognized gain is in the second short leg. This is plainly an appropriate case for loss deferral under the principles of section 1092; but it is thought that because the second short leg is not "offsetting" to the first short leg, the literal language of section 1092(a) does not apply.[25] Therefore, the scheme

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[24] Put another way, "realization accounting" still applies to commodity interests.

[25] The draftsmen of the 1981 Act could, for example, have decided that these three positions -- the long and the (Footnote Continued)

requires a loss deferral rule based on a notion of replacement or "successor" positions; this is the wash sale principle referred to by section 1092(b)(1). The difficulties arise in attempting to define and implement this concept.

Nevertheless, we believe that the appropriate results in the various examples in the Regulations can be reduced to a few operative principles. First, wash sale loss deferral for straddles is required only to the extent of unrecognized gain in some component position (or positions) at year end. Second, unrecognized gain at times other than year end is irrelevant. Third, tax consequences may well vary depending on whether positions are disposed of and reestablished, rather than merely held continuously. Fourth, loss deferral is required only if some chain of offsetting positions can be traced between the realized loss and the year-end unrecognized gain. This last test is extraordinarily difficult to articulate, and is best understood in light of our analysis below of the specific

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(Footnote Continued)
[25] two successive shorts -- form a single straddle, similar to the "larger straddle" concept of sections 1092(a)(2)(B)(iii) and 1092(c)(4)(A)(ii). That they rejected that interpretation is evident from the continuing vitality of the "thirty-day" rule for wash sales: staying open (i.e., one-sided) for thirty days prevents the application of the wash sale version of the loss deferral rule, while no such thirty-day exception applies to loss deferral with respect to simple, two-position straddles. See General Explanation, 1981 Act at 286.

examples. We suggest that the following definition of a "successor position" may be adequate:

> A position ("P") is a successor position to another position (the "original position") if P is offsetting either to a position that formed part of a straddle with the original position or to any other successor position to the original position.

To incorporate the concept of a thirty-day limitation, an additional sentence is needed, along the following lines:

> For purposes of the preceding sentence, however, no position P will be considered offsetting to a position that formed part of a straddle with the original position or to another successor position unless P is entered into during a period beginning 30 days prior to and ending 30 days after the disposition of the original position or other successor position, as the case may be.

B. Detailed comments

Section 1.1092(b)-1T(a). This section implements the basic rule: unrecognized gain in "successor positions" or "offsetting positions to the successor positions" causes deferral of realized losses. We suggest above that the definition of "successor position" sweeps too broadly. A redrafted definition of "successor position" may require corresponding changes to this section. For example, our recommended definition would require this section to read more simply: "loss . . . shall not be taken into account . . . to the extent there is unrecognized gain in a successor position."

Note also, that by including subclause (2), which refers to "offsetting positions to the loss position," but not

to wash sale principles, the Regulation in effect attempts to implement the general loss deferral rule. Perhaps a cross-reference instead to the (forthcoming) section 1092(a) regulations would be preferable. As noted in the discussion of Example 4 below, the examples should make clear that loss disallowance to the extent of unrealized gain will occur even though the taxpayer may have unrealized year-end loss in some other position which offsets such unrealized gain. In addition, we recommend a further example illustrating the principle that unrealized gain in a leg of an identified straddle within the meaning of section 1092(a)(2) will not cause deferral of a loss realized with respect to a position outside of such identified straddle.

Section 1.1092(b)-1T(f), introductory sentences. It is recommended, for the reasons discussed at pages 8-9 above, that this paragraph include a remark to the effect that "for purposes of these examples, each long position is assumed to be offsetting to each short position." This or a similar disclaimer would seem necessary to avoid implicitly addressing the issue of whether (and to what extent) long and short positions should be treated as not offsetting because not "balanced".

Section 1.1092(b)-1T(f), Examples (1), (2) and (3). These examples attempt to present the basic loss deferral rule: A goes long and short at the same time; the price shifts; A

disposes of his loss position and realizes a loss; without establishing any other position, A carries the gain leg past the end of the taxable year. A must defer his loss to the extent of his unrecognized gain at year end. The facts of the three examples differ only as to the amount of unrecognized gain at year end. The examples illustrate two important points: (i) the amount of loss deferred is limited to the amount of unrecognized gain at year end and (ii) the amount of unrecognized gain at the time the straddle is terminated is irrelevant. The results in each of the examples are correct.

We recommend, however, that the examples be modified in three minor respects. First, Example (1) ought not to refer to a specific dollar amount of unrecognized gain at the end of the straddle (on December 10), since this is irrelevant to the conclusion. Instead, a sentence should be added, such as, "The amount of unrecognized gain on the offsetting position on December 10 does not affect this conclusion." In this way, the point is emphasized. Furthermore, when the facts are changed for subsequent examples, it becomes clear that this fact is not changed. Second, the dates in these examples should be changed to November in order to emphasize that the thirty-day wash sale rule generally does not apply to loss deferral.[26] That is, loss may be deferred even if one leg of the straddle is "open"

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[26] See the discussion of Example (15), p. 25 below.

for more than thirty days. Third, the examples needlessly assume that both legs of the straddle are opened on the same day.[27] The result is the same if the legs are opened on different days, and the broader fact pattern should be used.

Accordingly, we would recommend that the following be substituted for Example (1):

> Example (1). On November 1, 1985, A enters into a short position. On November 10, 1985, A enters into an offsetting long position. On November 30, A disposes of the short position at a loss of $11. At year-end, there is $5 of unrecognized gain on the remaining long position. Under these circumstances, $5 of the $11 loss on the short position will be disallowed for 1985 because there is $5 of unrecognized gain in the offsetting position. The remaining $6 of loss, however, will be taken into account in 1985. Neither the fair market value of the short position on November 10, nor the fair market value of the long position on November 30, affects the amount of loss that is deferred.

Examples (4), (5) and (6). These examples attempt to present the basic wash sale rule. In each example, A goes long and short on the same day; the price falls; A closes out the long position at a loss, while retaining the short leg; A reopens the long position on the next day and holds both positions through year-end. Example (4) is the standard wash sale example: the price returns to its original level and A's realized loss on the first long position is economically offset

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[27] Examples (4),(5) and (6) are similarly limited.

by an equivalent unrealized gain, also in a long position. In Example (5), the price moves only partway back toward its original level. In that case, there is some unrealized gain on the long leg, and also some unrealized gain on the short leg. Example (5) provides that both of these amounts of unrealized gain may defer the realized loss. That is, the same loss position may be matched both with a successor and with an offsetting position. Finally, Example (6) attempts to present the case where the price moves back beyond its original level, so that a single gain position (the successor long position) defers loss on both the earlier long position and the subsequent, offsetting short position. The results in each of the examples are again correct.

Once again, however, the examples are not as broad as they could be, and by failing to be general, raise unnecessary questions about the operation of the rules in similar cases. There are three places where the examples should be expanded.

There is even more of an implication in Example (4) than in Example (1) that the amount of unrealized gain at the time the straddle is terminated may be relevant because Example (4) makes that amount ($10) exactly equal to the amount of realized loss, which suggests that changing the dollar amount of unrealized gain would change the result.

Example (4) also states that there is no year-end unrecognized gain in the offsetting short position. It is not

clear whether there may be unrecognized loss. The potential implication -- especially when considered in conjunction with Example (6) where there is loss, but it is realized -- is that the unrecognized loss might be netted against the unrecognized gain in the successor position prior to application of the wash sale rule. The implication should be negated by stating (here or in Example (6)) that the amount of unrecognized year-end loss is irrelevant.

Example (6) does not entirely demonstrate its central principle, that unrecognized gain ($10) on the successor position may offset realized loss on both the offsetting ($2) and the original ($10) leg, at the same time. This is clearly the intent of the example, since it refers to the "total $12 loss" without differentiating between realized loss on the offsetting position and loss on the original position. Because of the choice of dollar amounts, the example could, however, be read to mean that the $10 of unrecognized gain on the successor position defers only the $10 of realized loss on the original long position and that the $2 of realized loss on the short position is not potentially subject to deferral. In order to illustrate this point, the amount of unrecognized gain and of deferred loss should both be $11.[28]

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[28] This revised example presents an ordering problem: does wash sale deferral apply prior to or after standard loss deferral? It is difficult to envision circumstances
(Footnote Continued)

A final minor suggestion: the use of the term "successor" position in the parenthetical clause in Example (4) is ambiguous. If it is used merely as a label, the terms "first long position" and "second long position" would be preferable. If it represents a conclusion, the example should specifically state that the second long position is a "successor position".

Accordingly, we recommend that the examples be redrafted along the following lines:

> Example (4). On November 1, 1985, A enters into a long position (the first long position). On November 5, 1985, A enters into an offsetting short position. On November 11, A disposes of the long position at a $10 loss. On November 15, A enters into a new long position (the second long position), which is offsetting to the retained short position. The second long position is a successor position. A holds both positions through year-end, at which time there is $9 of unrecognized gain in the second long position and an unrecognized loss in the short position. Under these circumstances, $9 of the realized loss will be disallowed for 1985, because there is $9 of unrecognized gain in the second long position, and because it is a successor position. The result is the same regardless of the amount of unrecognized loss in the short position at year-end or the amount of unrecognized gain in the short position on either November 11 or November 15.
>
> Example (5). Assume the facts are the same as in Example (4), except that there is $2 of

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(Footnote Continued)

[28] where the ordering rule makes a substantial difference. One would normally expect the more restrictive rule (here, wash sale) to apply first.

unrecognized gain in the short position at year-end. Under these circumstances, the entire $10 loss will be disallowed, since the total unrecognized gain in the successor long position and the offsetting short position ($11) exceeds the amount of recognized loss.

Example (6). Assume the facts are the same as in Example (4), except that there is $11 of unrecognized gain in the second long position, and that A disposes of the short position at year-end for a $2 loss. Under these circumstances, $11 of the total $12 loss will be disallowed because there is $11 of unrecognized gain in the successor long position.

As described above, we also recommend that an example be added illustrating the effect on wash sale transactions of the "identified straddle" rule of section 1092(a)(2). Under that provision, unrecognized year-end gain in a leg of an "identified straddle" does not require deferral of realized loss on positions not part of the identified straddle. That example could read as follows:

Example (6) bis. Assume the facts are the same as in Example (4), except that the taxpayer opens a second short position on November 15, and properly identifies that second short position and the second long position as an "identified straddle" under section 1092(a)(2). Under these circumstances the entire $10 of loss on the first long position is recognized in 1985.

Example (7). This example correctly illustrates the rule of section 1.1092(b)-1T(b), that a disallowed loss is carried over to the following year, and is subject to the same limitations in the following year. As the example illustrates a specific, self-contained point (that applies equally well to the general loss deferral provision), it should be placed at the end of the examples or, preferably, in section

1.1092(b)-1T(b) itself. A reference to the specific rule that it illustrates could profitably be included: "Although the $10 loss is treated as sustained in 1986, it is nonetheless not recognized in 1986, since it is subject in that year to the limitations described in paragraph (a)."

Example (8). This example attempts to illustrate the definition of "successor position." In the example, investor A goes long and short; prices rise; A closes out both the long and the short position. A's $10 gain on the long position is counterbalanced by a $10 loss on the short position. A then opens a second long position and holds it to year end. Unrecognized gain on the second long position does not defer the recognized loss on the short position.

This result is clearly correct -- in particular, the position that carries the unrecognized gain (the second long position) was never a part of a straddle -- but this set of facts is not the interesting case. Suppose that the second position is a short position rather than a long position and that again the second position (now a short) has unrecognized gain at year end. Is the loss on the first short position subject to deferral? One would think plainly not; the short position that carries the unrecognized gain was never part of a straddle. Unfortunately, however, the section 1.1092(b)-5T(n) definition of "successor position" would appear to require a

contrary result.[29] The wash sale rule should be no broader in the case of a terminated straddle than the loss deferral rule: the result in Example (8) should not change merely because the recognized loss is on the same side as the potential year-end gain (i.e., both from short positions).

The narrowly drawn facts in the example also bypass a secondary issue. Suppose that in Example (8) the loss position resulted in an $11 loss, so that A has a net loss from his closed-out straddle. Can unrecognized gain on the year-end long position defer that net loss? We think not: the second, long position is still not offsetting to the loss position. Is the result changed if the year-end position is on the short side rather than the long? Again, we think not.

Accordingly, we recommend that Example (8) be redrafted as follows:

> Example (8). On October 1, 1985, A enters into a long position. On October 5, 1985, A enters into an offsetting short position. On October 15, 1985, A disposes of the short position at an $11 loss and the long position at a $10 gain. On October 20, 1985, A enters into a long position identical to the original long position. A holds the second long position at year end. Regardless of the amount of unrecognized gain in the second long

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[29] This derives from the application of the alternative, parenthetical definition of "successor position": the second short position is a position that "would have been offsetting to the [long] position had the [long] position been held at the time the [second short] position is entered into", and meets each of the numbered requirements of paragraph (n).

position at year end, the entire $11 loss is allowed, since the second long position is not a successor position. If instead the position entered into on October 20, 1985 is a short position, the result is the same.

In order fully to implement this example, the definition of "successor position" in section 1.1092(b)-5T(n) must also be modified as suggested at p. 12 above.

Examples (13) and (14). These two examples should be considered next, since they expand (incorrectly, we think) on the result contained in Example (8). Investor A opens a long and short position; prices rise; A closes them both out. A has a $10 gain on the long position and a $10 loss on the short position. A short while later, A again opens a long and a short position. The examples conclude that, "because the second short position is a successor position", any unrecognized gain at year end on A's second pair of positions, whether on the long position (Example (13)) or on the short position (Example (14)) or even on both positions at once,[30] will defer the recognized loss. We think each of these results is incorrect.

Compare Example (13) to the modified Example (8). In the modified example, recognition of loss on a straddle is permitted, even net loss, where a third position is

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[30] Positions that are offsetting and that are established at the same time do not normally result in gain on both legs. Example (14) is dubious in this regard.

subsequently entered into. The first straddle has been terminated, and no position offsetting or successor to any of its component positions has survived. There is thus no unrecognized gain that could be carried forward when the third position was opened. Why should this result change because a fourth position is opened even later? Yet Example (13) says that it does, at least where the year-end gain is in the fourth position; and Example (14) then provides that loss is deferred to the extent of year-end gain on either the third or fourth position.[31]

To review the steps underlying our conclusion that the examples are incorrect, consider the following. First, suppose investor B opens a short position, lets prices rise, and disposes of it at a loss. B then opens a second short position, which he holds to year end. His loss is recognized regardless; there is no general wash sale rule for commodities positions. Second, suppose that when B opened and closed the first short position, he also opened and closed a long position

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[31] Note that Example (13) does not permit an inference that there is a section 1091-type wash sale rule for straddles. For example: investor X holds straddle A; he disposes of all of its legs at an overall loss; shortly thereafter he acquires straddle B. If X holds straddle B at year end, is his loss on straddle A postponed? Under a "pure" wash sale rule, the straddle A loss is deferred (i) regardless of whether straddle B has unrecognized gain, but (ii) only to the extent of net straddle A loss. Neither of these principles is implemented in Example (13).

(at a gain). B's loss is still recognized regardless (modified Example (8)); there is no opportunity for loss deferral through the use of balanced positions. Third, suppose in either case that when B opens the second short position, he also opens a long position (Examples (13) and (14)). There is still no reason to apply a loss deferral rule with respect to the first short position: every time he closes out that position, he closes out all other balanced positions he holds.

Now modify the facts in Example (13): in addition to the four positions described there, B opens a long position on March 1 that he holds until April 10. Now, the year-end gain on the long position opened on April 10 could have corresponded to the recognized March 10 loss on the first short position. To make the correspondence clear, suppose that prices had not changed until March 2, so that the first long position was not disposed of at a gain at all, but that the facts otherwise remained the same. B would have preserved at all times the possibility of a year-end unrecognized gain offset by a recognized loss, and he would have had no economic gain or loss at any time during the year. (Whether the amount of gain recognized upon disposition of the first long position is relevant -- we believe it is not -- is discussed below at p. 27

in connection with Example (16).) This fact pattern therefore contains all the elements of loss deferral.[32]

Loss deferral based on the existence of a successor position is designed to deal with cases where unrecognized gain on a straddle has been preserved and shifted to a position other than the original gain position. The straddle loss deferral rule of section 1092(a) should not apply to positions opened after all other positions are disposed of, if no unrecognized gain can be preserved through the use of offsetting positions. The ancillary wash sale rule should not expand the fundamental loss deferral rule in this regard.

Accordingly, we think the examples should be modified as follows:

> Example (13). On January 1, 1986, A enters into offsetting long and short positions. On March 1, 1986, A disposes of the long position at a $1 gain. On March 10, 1986, A disposes of the short position at a $10 loss. On March 15, 1986, A enters into a second short position that would have been offsetting to the long position disposed of on March 1, On April 10, 1986, A enters into an offsetting second long position. A holds both positions to year-end. Under these circumstances, the $10 loss will be allowed in 1986, regardless of the amount of unrecognized gain in the positions held at year end.

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[32] As a side effect -- in some sense, an essential one -- the facts of Example (14), modified identically, would become meaningful, and economic. Gain on both legs would now be perfectly feasible, since it corresponds to a recognized loss in the same manner as Example (5).

Example (14). The facts are the same as in Example (13), except that in addition A enters into a long position offsetting to the short position on March 2, 1986, and disposes of that position on April 8, 1986, realizing no gain or loss. The $10 of loss on the first short position will be disallowed in 1986 to the extent of any unrecognized gain on either of the positions held at year end.[33]

Example (15). Finally, we must consider the application of the thirty-day limitation. If our analysis up to this point is correct, there should be no loss deferral in existing Example (14). Example (15), which is identical to existing Example (14) except for the introduction of a thirty-day waiting period, also concludes that no loss deferral is necessary. If our analysis is correct, Example (15) does not distinguish between cases. Yet the thirty-day limitation is important and can be illustrated by a much simpler fact pattern. Investor C goes long and goes short; prices fall; C closes out his long at a loss. He waits thirty-one days. He opens a second long position. At year-end, there is unrecognized gain in each of his remaining positions. We suggest that the section 1092(a) "offsetting position" loss deferral rule applies -- the loss on the first long position is deferred by the unrecognized gain on the short -- but that the

[33] Note that this example, like the others, separates opening and closing of positions by at least one day. This avoids reaching any conclusion as to whether (and under what circumstances) positions that are closed and immediately reestablished have in economic fact been realized.

wash sale loss deferral rule does not also apply to defer the loss by the amount of unrealized gain on the second long position, because the second long position is neither part of the original straddle nor a successor position. (The facts are a variation of Example (5) and, perhaps, should take the place of existing Example (7).)

Examples (9) through (12). This set of examples attempts to continue to develop the wash sale rules. Example (10) adds the gloss that the second, "successor" position can be entered into before the first position is closed out. Other than this wrinkle, however, the entire set of examples illustrates no principle not already covered by Examples (4) through (6) as modified. Each of the results in Examples (9) through (12) is correct.

The set begins with Example (9). This example is the basic wash sale rule illustrated in Example (4): A goes long and also goes short; prices rise; A disposes of his short position at a loss. Five days later A replaces the short position; A holds both the second short and the original long position through year end. The example states that there is no year-end unrecognized gain or loss in either remaining position. It concludes, sensibly enough, that there is no loss deferral. This much is clear from Example (4) as modified; it merely combines Examples (3) and (4). Had this been the entire scope of Example (9), it would be unexceptionable (but

unnecessary). The example, however, adds the sentence, "By November 15, the value of the long position has declined eliminating all unrealized gain in the position." That sentence is in no way necessary to the result in this example (no loss deferral if no unrecognized gain at year end). Example (9) should be eliminated and the sentence, if thought desirable, added to Examples (11) and (12).

Example (10) is identical to Example (4), except that the second, successor position is opened up before (rather than after) the first position is disposed of. The point is valid, and the example is helpful. It should, however, refer not to Example (9) (which we think superfluous) but to Example (4).

Example (11), in result, is identical to Example (5). Similarly, Example (12) is, in result, identical to Example (4). Presumably, the reason these two examples were added was to illustrate the effect of the extra sentence in Example (9) on the amount of unrealized gain at the time the successor position is entered into. The result is undoubtedly correct. But the issue is taken care of by the suggested modification to Example (4), so that Examples (11) and (12) could be eliminated.

Example (16). This example is, we think, the only example of this group whose result is unclear under the principles we develop above. In Example (16), A opens long and short positions; A closes out and reestablishes the short

position; later, A closes out and reestablishes the long position. At year end, A, therefore, holds long and short positions; indeed, he has maintained carefully balanced positions throughout. However, neither of the year-end positions was held at the same time as the offsetting position in the initial straddle, and the loss deferral rule in section 1092(a) is not directly applicable. Moreover, both legs of the original straddle were closed out. The example thus raises the question whether wash sale principles should apply when both loss and gain have been realized with respect to a straddle but balanced positions are maintained throughout through the establishment of successor positions. The issue is this: if on closing out the first long position A recognized gain, may he reduce the amount of his deferred loss to that extent? One would expect under pure wash sale principles that loss deferral is automatically eliminated by recognizing gain (so that no loss deferral rule need be invoked in the example). Nevertheless, the example seems to be an appropriate illustration of the interaction of the loss deferral and wash sale principles. The effect of the wash sale principles is to expand the definition of "offsetting positions." The loss deferral rule dictates that, except as provided in the identified straddle provisions, recognized gain is disregarded in determining the amount of disallowed loss. Therefore, we think the result in Example (16) is correct.

Example (17). This example illustrates the consequences of loss deferral for losses attributable to section 1256 contracts. Investor C acquires a section 1256 contract and an opposing position that is not a section 1256 contract. The section 1256 contract is disposed of at a loss. Unrecognized gain at year-end on the opposing position defers loss on the section 1256 contract; that loss when recognized in a subsequent year bears the same character (60% long-term, 40% short-term) it would have had in the first year had the loss not been postponed.

Oddly, however, the example introduces a third position, successor to the section 1256 contract, which does not ever contain gain or loss (even unrecognized). This third position does not affect the analysis, and could be eliminated. Alternatively the year-end recognized gain in the example could be shifted in part to the third position, offering that position a reason for participating in the transaction and illustrating once again the wash sale rule. Compare Example (5) above, at page 18.

Finally, the example carefully points out that the second, offsetting, gain position carries $20 of unrecognized gain at the time the section 1256 contract is disposed of. As with the comparable situations in Examples (1), (4, (9), the reference to the fair market value of the position during the taxable year is irrelevant and misleading, and should be eliminated.

IV. Holding period and short sale rules

A. In general

Like the wash sale rule, the short sale provisions of Code section 1233 predate the 1939 Code. In the typical fact pattern, Investor D holds stock for a period (say, three months) too short to claim long-term capital gain treatment. Being unwilling to continue his investment in the stock, but equally unwilling to settle for short-term capital gain tax treatment, D sells substantially identical property (for example, stock in the same company) short, either providing for delivery in the future or (equivalently) using borrowed stock to close the short sale and delivering his original stock to the lender after the holding period has been met. Section 1233(b) provides that D's gain (or loss) is short-term notwithstanding literal compliance with a long-term holding period. Section 1233(d) provides a complementary rule: if D incurs a loss on the short sale, the loss is long-term if D held any substantially identical property for the long-term holding period. This loss-recharacterization rule stems from a somewhat different principle -- that taxpayers should not be permitted to mismatch gains on stock with losses on short sales. The section prescribes an onerous ordering rule: if the character of any potential gain on any "substantially identical" property held by the taxpayer at the time the short

sale is opened would be long-term, any loss allowed on the short sale will also be long-term.

The advent of liquid commodities markets created opportunities for taxpayers to obtain similar results outside the reach of section 1233.[34] Taxpayers could claim long-term capital gain treatment on transactions that did not present substantial risk of price fluctuation for a full six months -- for example, the classic "cash and carry" transaction of physical gold combined with a short gold future.[35] Taxpayers could also arrange "mismatching" of gains and losses by holding offsetting positions through the six-month holding period. Thus it was thought necessary to expand the anti-avoidance "straddle" rules to encompass holding period considerations.

Section 1.1092(b)-2T addresses the "short sale" rule in the context of straddles. It reflects a number of important

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[34] Code section 1233 does apply by its terms to "commodity futures" in some circumstances. The limitations were such, however, that it applied only to the delivery of commodity futures in satisfaction of short futures -- producing the odd result that no short contract could generate long-term gain -- but did not apply, for instance, to the simple commodity cash-and-carry transaction. See footnote 9.

[35] Since the futures price of precious metals typically differs from the present or spot price only by an interest factor, a cash-and-carry transaction is the rough equivalent of the purchase of a discount bond. In particular, there may be gain on the physical side of the transaction even if the future is disposed of at no gain or loss, if the price of the physical gold rises in accordance with the initial expectation. See Rev. Rul. 74-226, 1974-1 C.B. 119.

principles. First, as with section 1233(b), the holding period is terminated without regard to whether there is some market risk for a long-term period. In particular, net gain from a straddle is short-term. (Remember the classic "cash and carry" straddle. The built-in gain, equivalent to interest, must be taxed at short-term rates.) Second, like section 1233(b), the holding period is suspended for purposes both of gain and of loss. Third, if section 1233(d) would apply, loss is recharacterized as long-term regardless of whether any offsetting long-term gain is ever actually realized.

One other point should be mentioned. Section 1233 and section 1092(b), of course, apply generally to different types of transactions. For example, short sales of privately traded stock are not subject to section 1092; commodity transactions other than futures are generally not subject to section 1233. Thus it is necessary that section 1233 continue to terminate the holding period even though an exception to section 1092 is available.

B. Detailed comments

The Regulations generally adequately reflect these principles. Section 1.1092(b)-2T(a)(1) provides the general rule that for any position that is part of a straddle, the holding period does not begin until the straddle is terminated. Section 1.1092(b)-2T(a)(2) provides that long-term treatment is permitted for a position where the position has been held for

the requisite period prior to creation of the straddle; the paragraph clearly implies that the holding period is not merely suspended but terminated upon creation of a straddle. Thus, the special rule of section 1.1092(b)-2T(a)(2) preserves long-term treatment if the position has met the long-term holding period requirement prior to creation of the straddle, but the creation of the straddle a day before the holding period requirement is met reduces the holding period to zero.

Section 1.1092(b)-2T(b)(1) is intended to provide the general rule for the loss-recharacterization analogue: loss is long-term loss if any offsetting position is capable of generating long-term gain.[36] Section 1.1092(b)-2T(b)(2) properly provides that the long-term loss rule (but not the holding period termination rule) must be modified where the mismatching involves regulated futures contracts subject to "60/40" treatment: where there are no long-term holding period

[36] Actually, paragraph (b)(1)(ii) goes beyond this to require that long-term holding period in any position of the straddle will cause recharacterization, even if the long-term position is not offsetting, i.e., is on the same side as the subsequent loss position. Unlike the comparable loss deferral situation, we can see no opportunity for transferring holding period to subsequent positions, and, therefore, no need to phrase the rule so broadly. Accordingly, paragraphs (b)(2)(i) and (b)(2)(ii) could be joined together to read " . . . one or more positions offsetting to the loss position with respect to which all gain or loss would be treated as long-term capital gain or loss . . . ."

positions, but there is a "60/40" position, loss is recharacterized to the extent of 60 percent.

Section 1.1092(b)-2T(c) provides exceptions. The principal necessary exceptions include (i) ordinary income transactions, for which holding period considerations are irrelevant,[37] and (ii) positions subject to the special "mixed straddle" elections, the "mixed straddle account" or the "section 1092(b)(2) identified mixed straddle". (A third exception, for positions protected through the "identified straddle" definition of section 1092(a)(2), is implicit in the definition of "offsetting position" in section 1092(c)(2)(C) and does not need to be treated separately here.)

Section 1.1092(b)-2T(f), Example (1). This example presents the classic short sale transaction: investor E holds physical gold for less than six months until he enters into an offsetting short forward; E later sells the physical gold more than six months after he bought it. E's holding period is terminated too soon to get long-term treatment, and the example so provides. However, the example is limited in two

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[37] The regulation phrases this exception as pertaining to "hedging transactions." It is of course generally true that section 1092 does not apply to hedging transactions. See section 1092(e). However, it may also be true that other ordinary income transactions should fall outside the scope of the short sale rules. For example, even if a capital asset position is treated as offsetting an ordinary income position such as inventory, should loss on the capital asset be treated as long-term loss merely because the inventory is held for more than six months?

unnecessary respects. First, it carefully points out that the offsetting forward contract is closed out "at no gain or loss." This should be irrelevant to the result, since the holding period on the physical is terminated nevertheless. Therefore, that phrase should be eliminated. Second, the example carefully points out that the physical gold is sold at a gain. It is clear (although perhaps understated) that the holding period termination rule of section 1.1092(b)-2T(a)(1), like that of Code section 1233(b), applies equally to losses as well as gains; the example should not be limited. We recommend that the words "at a gain" be eliminated, and that the final sentence be revised to read ". . . gain or loss recognized . . . will be treated as short-term capital gain or loss." (Alternatively, one of the following examples -- e.g. Example (2) or (3) -- could be revised to refer explicitly to a loss.)

Example (2). This example is apparently identical to Example (1), except that the second position acquired is a section 1256 contract. Thus this example properly points out that a section 1256 contract can cause holding period termination of another position; it might also be pointed out that the gain or loss on the regulated futures contract continues to carry 60/40 treatment.

Example (3). This example is apparently identical to the second example, except that the second position is promptly

disposed of and the first position held open, in all, longer than six months. This example, therefore, distinguishes between holding period termination and mere suspension, and illustrates that section 1.1092(b)-2T(a)(1) requires termination. Again, there is no need to provide specifically that the offsetting short futures contract is terminated without gain or loss, as the result should not depend on that fact.

Example (4). This example illustrates the loss recharacterization rule. A long position held for the required long-term period is then offset by a short position later closed out at a loss. The example properly provides that loss on the short position is recharacterized, since at the time established the taxpayer held an offsetting position that had been held for the requisite long-term holding period. However, as with the earlier examples, this fact pattern is unnecessarily specific. First, the recharacterization does not depend on whether the long-term position is in fact closed out at a gain, nor on whether it is closed out prior to the realization of the recharacterized loss. The example should so state. Second, the example should reverse the long and the short, to clarify that long-term treatment is indeed possible on the short side of a commodity contract other than a future. (See footnote 9.)

Example (5). This example correctly illustrates the loss recharacterization rule in the special case of section 1256 contracts. Investor F enters into a forward offset with a futures contract; the example warns that loss on F's forward contract -- otherwise short-term -- is made 60/40 regardless of whether gain on the 60/40 futures contract is ever realized. In the example, the forward contract is established first; unlike the classic section 1233(d) situation, it is possible here for a short-term position (the forward) to be acquired before a position that gets long-term gain treatment. The example could perhaps carry additional emphasis if it were juxtaposed with (or referred to the facts of) Example (2) -- the corresponding case with the forward disposed of at a gain, which becomes entirely short-term gain.

Example (6). This example carries on Example (5) by positing that, in addition, the futures contract is subsequently closed out at a gain. The example serves to illustrate that the treatment of gain on the futures contract is unaffected by the holding period termination rule. The example could perhaps be improved by pointing out that neither gain nor loss on such a section 1256 contract is affected by termination of the holding period. Furthermore, the example as drafted could create the impression that the failure to terminate the holding period could depend on the recharacterization of loss on the offsetting leg of the

straddle; perhaps it would be more appropriate for this example to refer to the facts of Example (2).

Example (7). This example correctly presents the only circumstance where gain or loss on a section 1256 contract can be affected by these rules. If a non-section 1256 position (here, a long gold forward) is held for more than six months and then an offsetting section 1256 position (here, a short gold future) is entered into, the 40% short-term loss on the future is recharacterized by section 1.1092(b)-2T(b)(1) to long-term loss.

V. Identified Mixed Straddles

A. In general

The third major section of the Regulations, section 1.1092(b)-3T, implements the new scheme of identified mixed straddles, or more formally "section 1092(b)(2) identified mixed straddles". A mixed straddle consists of acquiring a futures contract together with an offsetting (off-market) forward contract. Recall that as a result of the short sale rules contained in section 1.1092(b)-2T and analyzed in the preceding section, the following consequences ensue upon entering into a mixed straddle where all of the positions are acquired at approximately the same time:

> Gain on the forward contract is always short-term.
>
> Gain (and loss) on the futures contract is always 60/40 long-term.

> Loss on the forward contract is never better than 60/40 long-term, and can be completely long-term if the positions are held together for more than six months.

Under this scheme, holders of mixed straddles are frequently forced to recognize gain and loss on the separate positions that do not match in character. Under the pure circumstances discussed in the examples -- no other positions held by the taxpayer -- the short-term gains on the physical positions are absorbed to the extent of offsetting long-term losses on futures contracts. Normally, however, the simultaneous recognition of short-term gain and long-term loss works to a taxpayer's dramatic disadvantage.

The draftsmen of the 1984 Act attempted to redress this circumstance by providing for an election to allow an individual straddle to be taxed on a net basis -- for gain or loss to be determined on that straddle before application of the more general netting rules of Code section 1222. The election and its consequences are spelled out in great detail in the General Explanation of the 1984 Act prepared by the Staff of the Joint Committee on Taxation at 317-19. Regrettably, however, the Regulations overly complicate the consequences of the election, which ought to be expressed as a simple set of operating rules.

The primary point of the Explanation's description of identified mixed straddles is that gain or loss should be

reckoned upon conclusion of the mixed straddle, and that that conclusion and reckoning should take place as soon as the first of the straddle positions is disposed of. One approach -- even simpler than the Joint Committee's approach -- would be to require immediate recognition of all gain or loss on all positions in the mixed straddle at that time.[38] However, the Joint Committee recognized that immediate recognition treatment for off-market positions not disposed of was not necessary to ensure consistency. Instead, the General Explanation continues to permit nonrecognition treatment, stating that "all post-straddle period gain or loss, as to amount and treatment as short-term or long-term, is to be determined without regard to gain and loss attributable to the straddle period."[39]

The general rule for identified mixed straddles can thus be simply stated: at the earliest time any position that is part of the straddle is disposed of the straddle terminates. Gain or loss on each position comprising a part of the identified mixed straddle is then determined. Net gain or loss is 60/40 to the extent attributable to futures contracts, and

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[38] Requiring recognition treatment has some precedent. Recognition of all unrealized gain or loss at inception of the straddle is a precondition to making the mixed straddle election.

[39] Of course, nonrecognition treatment of gains in effect applies only to the net (year-end) gain from a straddle, since recognized loss in excess of recognized gain is automatically deferred to that extent under the loss deferral rule of section 1092.

short-term gain or loss to the extent attributable to off-market positions. Gain and loss attributable to section 1256 contracts is recognized immediately. (This has no practical consequence, since gain is recognized at year end in any event.) Gain or loss attributable to off-market positions actually disposed of is also recognized immediately. Gain or loss attributable to off-market contracts not disposed of (which we will call "surviving forwards") is not recognized currently, but instead is postponed and recognized upon disposition (and, it may be pointed out, unrecognized gain on such a position may cause deferral of recognized loss through application of the loss deferral rule of section 1092).

The Regulations segregate identified mixed straddles into those where all positions are simultaneously disposed of, those where all futures positions are simultaneously disposed of, those where all off-market positions are simultaneously disposed of, and "hybrid" straddles not satisfying any of the previous descriptions. There is no need to reach this level of complexity. In particular, much attention is given in the Regulations to the mechanics of the "adjustment (through an adjustment to basis or otherwise)" to the otherwise recognizable gain or loss on futures contracts at year end. It should be adequate merely to state that appropriate adjustment to the gain or loss on subsequent disposition will be made to

reflect the gain or loss recognized on such section 1256 contracts by reason of termination of the straddle.

One does need to prepare two specific examples illustrating aspects of the rule that are not immediately obvious, i.e., that differ from immediate recognition of gain and loss from all positions in the straddle. The first example illustrates postponing a recognized loss because of an unrecognized gain on a surviving forward, and could be expressed as follows:

> On December 1, 1985, A enters into a mixed straddle consisting of one short futures contract and one long forward contract, which is properly identified by him as a "section 1092(b)(2) identified mixed straddle". On December 15, 1985, A disposes of the futures contract at a $10 loss. On that date, the forward contract has a fair market value of $12 (i.e., if A were to dispose of the forward contract on that date, he would recognize a gain of $12). At year end, the fair market value of the forward contract has declined to $11. A has a short-term gain of $2 from the straddle and a short-term loss of $1 attributable to the post-straddle period. A does not recognize any loss for 1985, since the entire amount of his realized loss from the futures contract is deferred under section 1092 by reason of the $11 of unrecognized gain on the forward position. However, if the value of the forward position had declined instead to $9, A would recognize $1 of short-term loss in 1985.

The second example would illustrate that gain on a surviving forward could, under appropriate conditions, be both long-term in part and short-term in part:

> On January 1, 1985, A enters into a mixed straddle consisting of one short futures contract and one long forward contract, which is properly identified by him as a "section 1092(b)(2) identified mixed straddle". On March 1, 1985, A disposes of the futures contract at a $10 loss. On that date, the forward contract has a fair market value of $12. A holds the forward contract until December 1, 1985, at which time he disposes of the contract for an aggregate gain of $15. A has $2 of gain from the straddle, which is short-term because attributable to the forward contract, and $3 of gain which is post-straddle period gain, and which is long-term because A has held the forward position for more than six months from March 1, 1985.

Assuming, however, that the structure of the proposed Regulations is to be retained, our remarks follow.

B. Detailed Comments

Section 1.1092(b)-3T(a). The term "section 1092(b)(2) identified mixed straddle" is used throughout the Regulations (see, *e.g.*, section 1.1092(b)-2T(c)(2)), and its definition should be highlighted.

Section 1.1092(b)-3T(b)(2). The Regulations fail to describe the possibility that net gain from a section 1092(b)(2) identified mixed straddle could be both short-term and 60/40 to some extent. The words "If . . ." that begin the third and fourth sentences should be replaced by the words "To the extent that . . . ."

Section 1.1092(b)-3T(b)(2), Example (6). The example proposes to disallow net loss from a section 1092(b)(2)

identified mixed straddle where an unrelated position has unrecognized gain at year end. The result is justified under the wash sale principle as involving an advance successor position -- a position entered into within 30 days prior to the date the loss position is disposed of. We doubt the result is correct. First, the example should in all events be amplified to state that no "identified straddle" identification is made under section 1092(a)(2).[40] Second, the offending unrecognized gain position presumably has not caused the straddle to become "part of a larger straddle", since it would thereby no longer qualify as a "mixed straddle". See section 1.1092(b)-5T(e)(4). Finally, the fact that the offending position is entered into shortly before year end suggests that the example relies on the wash sale rule -- that is, it suggests that loss deferral might not have been necessary had the position been entered into in November instead. As discussed above in the first section of this Report, we do not

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[40] We expect that, in the ordinary course, "identified straddle" elections will automatically be made for "section 1092(b)(2) identified mixed straddles." The only substantive precondition for an "identified straddle" election is that all positions be opened on the same day. This requirement is, or should be, satisfied automatically in the case of identified mixed straddles by the accrual and recognition of pre-straddle gains and losses. See General Explanation, 1984 Act at 317; section 1.1092(b)-3T(b)(6). Although these Regulations do not specifically relate to the "identified straddle" election, a clarifying remark to this effect should be added.

believe that the wash sale rule would be appropriate where the loss deferral rule itself could not apply for absence of a "straddle".[41] Accordingly, we recommend the example be withdrawn. See also section 1.1092(b)-3T(c), which is unclear in any event.

Section 1.1092(b)-3T(b)(3), Examples (3) and (4). The draftsman's reluctance to require immediate recognition of gain on futures contracts shows through most awkwardly in these two examples. Example (3) requires uneconomic facts; an aggregate loss of $350 offsets an unrealized gain of $100. For that reason alone, the example should be reconsidered. In Example (4), the reader is left with the implication that the recognition of at least $250 of gain on the disposed of section 1256 contract has some significance. In fact, whether net gain from the straddle can specifically be made attributable to realized section 1256 contracts should be irrelevant, so long as there is adequate net gain from the straddle taking into account all section 1256 positions realized or unrealized.

Section 1.1092(b)-3T(b)(6) (title). Both the Joint Committee Explanation and the Regulations use the term

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[41] Consider Example (6) with all of the mixed straddle recognition/disposition dates made one month earlier, that is, with the mixed straddle completely disposed of in November. Now the new position is still a "successor position" -- since entered into within thirty days after disposition of the mixed straddle -- but loss deferral is hardly appropriate.

"accrued" to describe unrealized gain and loss on commodities positions. We suggest the term is inapt, since under no method of accounting -- even the accrual method -- is that gain or loss properly "accrued". The Regulations do not use the term for any purpose other than the title of that section; it ought to be removed.

Section 1.1092(b)-3T(b)(7), Example. This example is the closest to the second recommended example above. It should be pointed out in the example that the same bifurcated treatment of long- and short-term gain from the surviving forward applies even if some of that short-term gain is net gain from the straddle; the facts could be modified to allow for net gain on the straddle. The crucial conclusion of the example is that because of $1,000 of gain on the surviving forward at the time the straddle is terminated the remaining $500 of eventual gain on the forward is ipso facto "attributable to the post-straddle period." This should be expressed more forcefully as a conclusion rather than as another "fact." Finally, it is interesting to note that the result to the taxpayer in this circumstance is much worse than the comparable result -- 60/40 loss, long-term gain on the entire "surviving forward" gain -- had the mixed straddle identification not been made.

VI. Mixed straddle accounts

A. In general

The final substantive section of the Regulations, section 1.1092(b)-4T, describes the rules pertaining to the second major special exception for mixed straddles: the "mixed straddle account." This account was designed for taxpayers with such a large quantity of mixed straddle transactions that transaction-by-transaction identification of straddle positions would be impractical. As with the "section 1092(b)(2) identified mixed straddle" provisions, the rules for operation of mixed straddle accounts are carefully spelled out in the legislative history. In general, mixed straddle accounts are to be established for classes of activities, such as "transactions in XYZ stock or stock options." All of the taxpayer's transactions of that type are posted to the account. Gains and losses from positions in the account must be periodically marked to market and netted, and are completely recognized at year end. Aggregate "account gain" may be no more favorable than 50% long-term, and aggregate "account loss" may be no more favorable than 40% short-term. Presumably, the "offsetting position" rules will generally not apply to positions in such a mixed straddle account.

There are several comments to be made on the implementation of the mixed straddle rules in the Regulations. First, there is an odd reluctance in both the operative

provisions (section 1.1092(b)-4T(a) and -4T(b)) and the examples to acknowledge that a mixed straddle account, once established, applies to all positions then or thereafter acquired that fall within the designated class of activities. This should be obvious, but the introductory language in section 1.1092(b)-4T(b)(1) refers to "positions held . . . by the taxpayer at the time the taxpayer elects to establish" a mixed straddle account; nowhere is any provision made for revoking an election, say, with the Commissioner's permission; and each of the examples carefully avoids referring to any position acquired after the date the mixed straddle account is established. Certainly this point should be clarified. In particular, the Regulations should firmly state that whether a position is posted to a mixed straddle account is not optional with the taxpayer.[42]

Second, the Regulations unnecessarily restrict the Commissioner's power to require accurate account classification. They rely on a two-stage "class of activities" standard. The taxpayer is first supposed to designate a "class of activities," positions in which are posted to the account. The Commissioner may attempt either to claim that the designated

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[42] There is an unfortunate implication to the contrary in the General Explanation, which refers to the treatment of "positions transferred to and from the account." General Explanation, 1984 Act at 321. This must refer only to the Commissioner's adjustments pursuant to section 1.1092(b)-4T(b)(4), (5) and (6).

class of activities is over-inclusive or inadequate to encompass transactions normally considered "offsetting", or to claim that a single transaction belongs within the taxpayer's designated class. The Regulations thus appear to forswear the opportunity to require posting (or removal) of individual positions that result in a distortion of income. An example should make this clear. Investor G designates a class of activities to be gold transactions. If he were instead to designate only gold futures transactions, in order to create "cash and carry" transactions, he would lose: the Commissioner could easily contend that any sensibly-defined class would have to include gold physical as well as gold futures positions. If he were instead to neglect to include a single short gold forward in his mixed straddle account in order that it form part of a tax straddle with other positions in the account, G would lose: the Commissioner would require him to include that position since it falls within his self-admitted class of gold transactions. The flaw in this system, though, is that G may define a class of activities -- such as gold transactions -- innocuous enough to pass scrutiny unless G's individual transactions are examined. Suppose G forms the simple "larger straddle", consisting of short December gold, long February gold, and long February (three-month) Treasury bill.[43] His

[43] The futures price of gold generally can be related to the current, or spot, price by the cost of carrying gold from (Footnote Continued)

gold spread is posted to the mixed straddle account, and his Treasury bill forward insulated from that account. Treasury bills are not gold, and interest rate futures or forwards are not so closely connected with gold transactions in general that G's designation of "gold transactions" as a permissible class must automatically include all Treasury bill forwards. Now G has a classic straddle, insulated from the straddle rules: loss on the gold spread will be recognized and corresponding gain on the Treasury bill forward can be deferred unrecognized. (Of course, if the gold spread reflects a gain at year end, G will have to recognize it, so he will arrange to dispose of his Treasury bill forward and be content to break even.) The point of the example is that individual transactions can easily distort income where the definition of the designated class of activities is too straightforward to require those types of transactions to be included (or excluded) in all cases. We would, therefore, recommend that the Commissioner reserve the

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[43] (Footnote Continued)
the present to the future date of delivery. For gold and other precious metals, that cost of carry is largely interest cost. Therefore, the difference between the spot price and the futures price for delivery three months hence is linked to the current three-month borrowing rate. Similarly, the difference between the three-month futures price (December, say) and the six-month futures price (March) is the three-month borrowing rate from December to March; but that is (nearly) identical to the futures price of three-month Treasury bills issued in December and maturing in March. See, e.g., Rothstein, The Handbook of Financial Futures, at 76 ("spreading is less a bet on the general market direction [of gold] than on interest rates").

opportunity to require individual positions to be posted to (or removed from) the account where necessary "to insure that income is clearly reflected."[44]

Alternatively, the appropriateness of the taxpayer's choice of "class of activities" could be explicitly determined in light of his actual transactions. If this approach is taken some greater illustration of the types of "classes" that the Commissioner will normally find convincing could be given. The simple example in the Regulations -- all of the taxpayer's transactions in XYZ stock or XYZ stock options -- is simple enough, but additional examples would be helpful. The Regulations need to include a general reminder that taxpayers may not rely on the literal language of their own designation to forestall a challenge to a subsequent distortion of income.

The Regulations (section 1.1092(b)-4T(b)(2)) introduce a "reasonable person" standard in determining the adequacy of a class designation. That is, a permissible designation is a class containing "positions that a reasonable person . . . would ordinarily expect to be offsetting positions." In the narrow context of recharacterization of a class of activities included in a mixed straddle account, the notion of protecting a "reasonable" attempt at compliance makes some sense. The Regulations should make clear, however, that the "reasonable

[44] See General Explanation, 1984 Act at 321.

person" standard is based on reliance, and is to be invoked by the taxpayer to support his designation, not to expand the Commissioner's discretion to include viewpoints that have only "reasonable" support. Otherwise, the "reasonable person" standard adds nothing to the analysis: positions that a reasonable person would ordinarily expect to be offsetting are offsetting, or else the statute is too confusing to be interpreted correctly.

Even with the "reasonable person" concept, the underlying standard for account designation should still be expressed with care. In current markets, one can find offsetting positions with respect to most individual types of property, so that a designation of any class of trading activities automatically means that some transactions in that class will offset others. (Unless, of course, a taxpayer designates "long positions in gold"; but that is perhaps too obvious.) This leads to some logical inconsistencies in the Regulations. For example, section 1.1092(b)-4T(b)(4)(i), pertaining to splitting up a designated class into smaller classes, should not refer to positions that would not be offsetting to other positions in the account, but instead should refer to two (or more) classes of activities, the positions in each of which would not ordinarily be expected to offset positions in the other.

It should be noted in passing that no reasonable person would agree that an option on a broad-based stock index "substantially diminishes" the risk of loss on three single underlying stocks.[45] In particular, whether options are offsetting to positions in the underlying property may well turn on the strike price for the option. Unfortunately, we can think of no particularly good substitute fact pattern to illustrate the concept of the example, that a single position can be allocable to more than one mixed straddle account. Indeed, we suspect that the entire section 1.1902(b)-4T(b)(3) should be eliminated.

Finally, the Regulations (section 1.1092(b)-4T(c)(1)) take the position that "daily" netting of gain and loss of positions in a mixed straddle account is required in all cases. Admittedly, the General Explanation authorizes the Regulations to require netting on a periodic basis "which may be a daily or less frequent basis."[46] There does not seem to be any overwhelming need, however, for continuous "periodic" netting. Presumably, the requirement for "periodic" netting stems from a fear that taxpayers will succeed in creating 60/40 gain matched (in different periods?) by short-term loss, but it is difficult to understand how frequent netting eliminates this beyond a

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[45] Compare section 1.1092(b)-4T(b)(3), example. See also discussion above, page 8 and note 17.

[46] General Explanation, 1984 Act at 319.

general desire to match offsetting transactions with each other. In particular, year-end (and periodic) gain and loss is marked to market in any event. Of course, the more frequent the "netting", the more likely the taxpayer is to finish at year end with substantial amounts of long-term gain and short-term loss, or vice versa, as a pure matter of statistics. Since the odds are in some sense stacked in favor of the government (the 50%/40% rule of section 1092(b)(2)(B)(i)), insistence on frequent netting as well may be unnecessary. We would, therefore, suggest that the requirement could be made less onerous, at least until the Service has had better opportunity to gauge the recordkeeping burdens and the tax avoidance opportunities.

VII. The Married Put Rule

A. The Statutory and Regulatory Framework

Section 1.1092(b)-2T(a)(1) provides that "[e]xcept as otherwise provided in this section, the holding period of any position that is part of a straddle shall not begin earlier than the date the taxpayer no longer holds directly or indirectly (through a related person or flowthrough entity) an offsetting position with respect to that position." Section 1.1092(b)-2T(a)(2) provides that the general rule of section 1.1092(b)-2T(a)(1) will not apply to a position held by the taxpayer for the long-term capital gain holding period (or longer) before a straddle that includes that position is

established. The effect of section 1.1092(b)-2T(a) is that gain realized on the disposition of positions that are part of a straddle (other than (i) positions that qualify for the exception contained in section 1.1092(b)-2T(a)(2) and (ii) section 1256 contracts generating "60/40" gain) will be treated as short-term capital gain.

Section 1.1092(b)-2T(a) was promulgated by the Internal Revenue Service under the authority of section 1092(b)(1). Section 1092(b)(1) provides in pertinent part that "[t]he Secretary shall prescribe such regulations with respect to gain and loss on positions which are part of a straddle as may be appropriate to carry out the purposes of [section 1092] and section 263(g). To the extent consistent with such purposes, such regulations shall include rules applying the principles of [subsections (b) and (d) of section 1233(b)]."

Section 1233(b) provides that "if gain or loss from a short sale is considered as gain or loss from the sale or exchange of a capital asset under [section 1233(a)] and if on the date of such short sale substantially identical property has been held by the taxpayer for not more than 6 months . . . or if substantially identical property is acquired by the taxpayer after such short sale and on or before the date of the closing thereof", then (i) gain on the closing of the short sale will be treated as short-term capital gain and (ii) the holding period of the substantially identical property will not

begin until the date of the closing of the short sale. For purposes of section 1233(b), the acquisition of a put is considered to be a short sale and the exercise or failure to exercise a put is considered to be a closing of a short sale.

Prior to the enactment of section 1092(b), the application of the recharacterization and holding period termination rules of section 1233(b) was limited, in one specific factual situation, by the "married put" rule of section 1233(c). Section 1233(c) provides that "[section 1233(b)] shall not include an option to sell property at a fixed price acquired on the same day on which the property identified as intended to be used in exercising such option is acquired and which, if exercised, is exercised through the sale of the property so identified."

Under section 1233(c), the acquisition of a "married put" will not trigger the application of section 1233(b) to the underlying long position to which the put is "married." Accordingly, prior to the enactment of section 1092(b) and its implementation by section 1.1092(b)-2T(a), that underlying long position would accrue a holding period in the normal manner.

Section 1092(b), as implemented by section 1.1092(b)-2T(a), substantially eliminates the married put rule of section 1233(c). In particular, any pair of positions qualifying under section 1233(c) (that is, a put option and an underlying long position identified as intended to be used in

exercising that option) should constitute a straddle so long as the underlying long position is "actively traded" within the meaning of section 1092(d)(1). Under section 1.1092(b)-2T(a)(1), the holding period of the positions comprising such a straddle will not begin until the straddle is terminated. Section 1.1092(b)-2T(a) contains no exception for straddles comprised of an underlying long position and a put married to that long position.

B. Policy Considerations

Section 1233(b) treats the acquisition of a put as equivalent to a short sale in order to prevent the use of puts to "lock in" the gain on, and to age the holding period of, positions on which unrealized short-term gain exists at the time the put is acquired. Thus, the Senate Finance Committee Report on the Internal Revenue Code of 1954 explained the reasoning underlying the enactment of section 1233(c), in pertinent part, as follows:

> [P]resent law provides a presumption that a "put" (an option to sell an asset at a fixed price) is a short sale. This prevents the use of a "put" to artificially extend a speculative commitment beyond 6 months. However, if a "put" is purchased with the stock which is to be issued to exercise it in order to hedge against a decline in its value, the taxpayer is denied long-term capital gains treatment. To avoid this result a "put" is not to be presumed a short sale if, among other things it is purchased at the same time as the stock to be used to fulfill the

contract."[47]

If the exercise price of the put is less than the original purchase price for the security, the married put rule may actually operate to the disadvantage of the taxpayer, by making the loss realized on the exercise of the put long-term loss.

Section 1092(b) has a broader policy than section 1233 and is more generally concerned with the treatment of straddles consisting of offsetting positions. Clearly, one objective was to afford the Commissioner flexible tools for preventing long-term gain conversions, as could occur if a put price exceeds the taxpayer's purchase cost and locks in a gain. Moreover, it can be argued that the failure of section 1092(b) to refer to the "principles of section 1233(c)" signals an intent not to incorporate the married put rule into the section 1092 regulations, although it might be argued to the contrary that section 1233(c) is merely an aspect of the principles of section 1233(b) (which are incorporated into section 1092(b)). Also, possible abuse situations could arise even when the put exercise price is below the taxpayer's purchase cost if the taxpayer acquires other positions identical to one or more components of the married put and, thus, could possibly affect

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[47] S. Rep. No. 1622, 83d Cong., 2d Sess. (1954), reprinted in 1954 U.S. Code, Cong. & Admin. News 4621, 4746-47. The House Ways and Means Committee Report on the Internal Revenue Code of 1954 contains substantially similar language. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 83 (1954).

the characterization of gain by the choice of whether to sell the put separately or exercise the put component of the married put with the security to which it is married or with another security. On the other hand, section 1.1092(b)-2T(a) itself potentially opens up possibilities of manipulation because it appears to permit a holding period for a position to be terminated and restarted through the temporary acquisition of an offsetting position. A better rule, and one which seems consistent with the statutory policy, might provide that the holding period for a position would be suspended when an offsetting position is subsequently acquired.

In view of the foregoing, the Committee has been unable to devise a substantive rule that is clearly preferable to the approach taken in the regulations and, accordingly, it makes no recommendation on this issue.

However, the Committee notes that it was by no means generally understood by the practicing bar that regulations under section 1092(b) would abrogate the married put rule. The Committee also notes that the Regulations did not directly amend the section 1233 regulations (for example, by cross-referencing the Regulations). As a result, many practitioners were not immediately aware of the impact of the Regulations on the application of section 1233(c). Accordingly, consideration should be given to providing a prospective effective date (for example, a date 90 or 180 days after the publication of the

Regulations). The section 1233(c) regulations should be amended to identify the interrelation between section 1233(c) and the Regulations, and it may be appropriate to issue an announcement on this subject so that other taxpayers will not be led astray by the present absence of such an amendment.