

TAX SECTION

New York State Bar Association

Proposed Regulation Section 1.1092fd)-2

October 6, 1995

Table of Contents

Cover Letter ..... i

I. INTRODUCTION. .... 1

II. BACKGROUND AND DESCRIPTION OF THE PROPOSED REGULATION. .... 2

III. SUMMARY OF COMMENTS AND RECOMMENDATIONS. .... 7

IV. COMMENTS REGARDING THE PROPOSED REGULATION. .... 13

    A. Exercise of Regulatory Authority. .... 13

    B. Mode of Analysis. .... 16

    C. The SSRP Standard and Risk Diminution. .... 22

    D. Effective Date. .... 25

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October 6, 1995

The Honorable Bill Archer  
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The Honorable Margaret M. Richardson  
Commissioner  
Internal Revenue Service  
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Washington, D.C. 20224

Re: Proposed Regulation Section 1.1092fd)-2

Dear Secretary Samuels and Commissioner Richardson:

I am pleased to enclose a report on the recently proposed Treasury regulation section 1.1092(d)-2, relating to the application of the straddle rules of section 1092 to equity swaps and other equity straddle strategies. The principal author of the report is Yaron Z. Reich, a Member At Large of our Executive Committee.

A key aspect of the proposed regulation is, as noted in the report, the treatment of an equity swap and actively traded stock as a straddle, where the swap and the stock constitute economically offsetting positions. The report supports this result. However, the report finds that the analysis employed to reach this result is strained, and notes several respects in which this analysis departs from prior thinking. Nonetheless, on balance the report supports the mode of analysis employed by the proposed regulation because, in contrast to a more straightforward analysis, it produces appropriate

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results in certain related areas (including the application of the straddle rules to straddles consisting solely of offsetting swaps, and the application of section 1234A).

The report also discusses the application of the dividends received deduction ("DRD") definition of "substantially similar or related property" in the section 1092 context. While the DRD and section 1092 standards are similar, they do differ, in that section 1092 looks not only to risk diminution on stock owned but also to risk diminution on the offsetting positions, and because risk diminution under section 1092 must be "substantial". The report suggests that that further guidance is needed to better coordinate these rules.

The report also comments on the effective date of the proposed regulations. Among other comments, it requests guidance clarifying the treatment of offsetting positions entered into with respect to stock acquired before 1984. The report suggests that the straddle rules should apply where positions are taken with respect to pre-1984 stock, but also notes that other interpretations are possible. Given the current uncertainty, the report recommends that regulations should apply the straddle rules only to positions that are entered into with respect to pre-1984 stock after Treasury's position on this issue has been formally announced, and should take no position as to the interpretation of the 1984 effective date provision during the years between the enactment of section 1092 and the announcement of Treasury's interpretation of this provision.

Finally, the report encourages Treasury and the IRS to turn to the many substantive issues that must be addressed now that the threshold of applying the straddle rules to equity swaps (and the like) has been crossed. The report lists a number of issues on which guidance is needed, including: the character of payments on swaps; the scope and application of section 263(g) to equity swaps that are part of a straddle; and the treatment of partial hedges, compound swaps, and multi-stock portfolio and nonportfolio positions. These are not all new issues, but the extension of the straddle rules to positions in stock make these issues important to a much larger universe of taxpayers.

We would, as always, be pleased to work with you in finalizing the regulations and addressing the next generation of issues they present. Please contact me if we can be of further assistance.

Very truly yours,

Carolyn Joy Lee  
Chair

October 6, 1995

**REPORT ON PROPOSED REGULATIONS SECTION 1.1092(d)-2**

**By**

**The New York State Bar Association Tax Section\***

**I. INTRODUCTION.**

This report comments on Proposed Regulations section 1.1092(d)-2 (the "Proposed Regulation")<sup>1</sup>. The Proposed Regulation was issued only six weeks after the promulgation of final Regulations section 1.1092(d)-2 (the "March Regulation")<sup>2</sup> in order to clarify the application of the straddle rules of section 1092 to equity swaps and other equity straddle strategies<sup>3</sup>

Part II of this report provides relevant background and describes the Proposed Regulation. Part III summarizes our comments and recommendations, while Part IV contains our detailed comments. As discussed in Part III, we believe that significant additional

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\* This report was prepared by Yaron Z. Reich. Helpful comments were received from John A. Corry, David P. Hariton, Mary Harmon, Carolyn Joy Lee, David S. Miller, Erika W. Nijenhuis, Richard O. Loengard, Richard L. Reinhold, Michael L. Schler and Elizabeth K. Weir.

<sup>1</sup> 60 Fed. Reg. 21,482 (May 2, 1995). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the Treasury Regulations promulgated thereunder.

<sup>2</sup> T.D. 8590 (March 20, 1995).

<sup>3</sup> Two previous reports of the Tax Section discussed this issue - "Report on Regulations To Be Issued Under Section 246(c) Restricting the Dividends Received Deduction," reprinted in 28 Highlights & Documents 3343 (March 3, 1993), and "Report on Proposed Regulations Sections 1.246-5 and 1.1092(d)-2" ("NYSBA Report"), reprinted in 31 Highlights & Documents 303 (October 7, 1993).

guidance is required regarding the application of the straddle rules to equity swaps and other equity straddle strategies.

## II. BACKGROUND AND DESCRIPTION OF THE PROPOSED REGULATION.

The straddle rules of section 1092 provide generally that (i) any loss with respect to a disposition of a "position"<sup>4</sup> in "personal property"<sup>5</sup> must be deferred to the extent that the taxpayer has unrecognized gain at year-end on any "offsetting position,"<sup>6</sup> and (ii) the holding period of property held as a position in a straddle (and not held for the long-term capital gain holding period prior to the establishment of the straddle) is terminated and does not commence until no offsetting positions exist.<sup>7</sup> In addition, under section 263(g), otherwise

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<sup>4</sup> The term "position" means an interest (including a futures or forward contract or option) in personal property. Section 1092(d)(2).

<sup>5</sup> The term "personal property" means any personal property of a type which is actively traded. Section 1092(d)(1). However, as explained below, stock is excluded from this definition except in certain circumstances.

<sup>6</sup> Loss must also be deferred to the extent of unrecognized gain on any successor positions or on offsetting positions to any successor position. The loss deferral rule is set forth in section 1092(a) and Regulations section 1.1092(b)-1T(a)(2). In general, positions are "offsetting positions" if there is a substantial diminution of the taxpayer's risk of loss from holding a position by reason of holding one or more other positions. Section 1092(c)(2). Section 1092(c)(1) defines a "straddle" as offsetting positions with respect to personal property.

<sup>7</sup> Section 1092(b)(1); Regulations section 1.1092(b)-2T(a)(1). The regulations further provide that loss on the disposition of a position in a straddle will be treated as a long term capital loss if the taxpayer held an offsetting position (or positions) on the day the loss position was entered into and all gain or loss with respect to any such offsetting positions would be treated as long term capital gain or loss if the offsetting position were disposed of on the day the loss position was entered into. Regulations section 1.1092(b)-2T(b)(1).

deductible interest expense incurred or continued to purchase or carry personal property that is part of a straddle (and other carrying charges) must be capitalized and treated as part of the basis in such property.

Prior to the promulgation of the March Regulation, the straddle rules generally did not apply to stock (other than in the case of straddles involving stock options), because section 1092(d)(3) provides that the term "personal property" generally does not include stock.

Specifically, sections 1092(d)(3)(A) and (B) provide:

(3) Special Rules for Stock.-For purposes of paragraph(1)-

(A) In General.- Except as provided in subparagraph (B), the term "personal property" does not include stock. The preceding sentence shall not apply to any interest in stock.

(B) Exceptions. - The term "personal property" includes -

(i) any stock which is part of a straddle at least 1 of the offsetting positions of which is -

(I) an option with respect to such stock or substantially identical stock or securities, or

(II) under regulations, a position with respect to substantially similar or related property (other than stock), and

(ii) any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder<sup>8</sup>.

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<sup>8</sup> Section 1092(d)(3)(C) contains a special rule under which, for purposes of subparagraph (B), subsection (c) (which defines "straddle" and "offsetting positions" is to be applied as if stock described in clause (i) and (ii) of subparagraph (B) were personal property.

The March Regulation exercises the regulatory authority granted under section 1092(d)(3)(B)(i)(n), and is generally effective for positions established on or after March 17, 1995. Thus, under the March Regulation, the straddle rules apply to a straddle consisting of stock and an offsetting position in substantially similar or related property ("SSRP") (other than stock). The definition of SSRP contained in Regulations section 1.246-5 (dealing with the corporate dividends received deduction ("DRD")) is generally applicable for this purpose.<sup>9</sup>

The Proposed Regulation would replace the March Regulation in its entirety. The Proposed Regulation does not change any of the substantive rules of the March Regulation, but purports to address all of section 1092(d)(3) and not merely section 1092(d)(3)(B)(i)(n). The Proposed Regulation clarifies that, for purposes of section 1092(d)(3)(B)(i)(II), a "position with respect to substantially similar or related property (other than stock)" does not include direct ownership of stock or a short sale of stock but includes any other position with respect to SSRP. The Proposed Regulation also clarifies that the stock must be of a type that is actively traded for purposes of sections 1092(d)(3)(B)(i)(I) (dealing with a straddle involving stock and an option with respect to such stock or substantially identical stock or securities) and 1092(d)(3)(B)(i)(n) (dealing with a straddle involving stock

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<sup>9</sup> For purposes of applying the SSRP test to swap contracts, Regulations section 1.246-5(c)(7) provides that rights and obligations under notional principal contracts are considered separately even though payments with regard to those rights and obligations are generally netted for other purposes.



and a position with respect to SSRP), but not for purposes of section 1092(d)(3)(B)(ii) (dealing with stock of a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder).

The Proposed Regulation also contains an example illustrating the application of its operative provisions to a taxpayer that holds stock and enters into an equity swap. In the example, a taxpayer (A) acquired 10,000 shares of actively traded X stock during 1990 and entered into a 3-year equity swap in September 1995. The swap contract provides that every quarter, A will pay appreciation on the X stock (measured from the previous quarter-end) plus dividends on the X stock, and will receive a payment equal to the depreciation on the X stock during the quarter plus LIBOR (measured on the value of 10,000 shares of X stock at the end of the prior quarter).

After noting that the swap substantially diminishes A's risk of loss with respect to the X stock, the example concludes that the swap and the stock are each "positions" with respect to "personal property", based on the following analysis:

1. The equity swap is a position with respect to personal property because the second sentence of section 1092(d)(3)(A) states that, "The preceding sentence [holding that the term "personal property" generally does not include stock] shall not apply to any interest in stock." The Proposed Regulation reasons that, "Therefore, stock can be personal property when testing whether an interest in the stock, other than a direct interest in, or a short sale of, the stock, is a position with respect to personal property.

Because the equity swap contract is an interest in actively traded stock, the equity swap contract is a position with respect to personal property."

2. The X stock is a position with respect to personal property by virtue of section 1092(d)(3)(B)(i)(II) (as implemented by the Proposed Regulation), for the following reason: (a) The swap is a position with respect to SSRP (other than stock) because it entitles A to payments that are attributable to the decline in value of the X stock but is not direct ownership of the stock or a short sale of stock, (b) The stock is treated as personal property for purposes of testing whether it satisfies the conditions of section 1092(d)(3)(B)(i)(II) by virtue of section 1092(d)(3)(C)(i). (c) The X stock satisfies those conditions (because the X stock and the swap are offsetting positions in personal property), so it is personal property for all purposes of section 1092.

3. Because ownership of the X stock and the equity swap contract are offsetting positions with respect to personal property, the X stock and the equity swap contract are a straddle to A within the meaning of section 1092(c)(1).

In general, the Proposed Regulation is effective for positions established on or after May 1, 1995. The preamble to the Proposed Regulation states, however, that the IRS believes that the Proposed Regulation merely clarifies the rule that applies as of March 17, 1995, the effective date of the March Regulation.

### III. SUMMARY OF COMMENTS AND RECOMMENDATIONS.

1. We support the decision by the Treasury and the Internal Revenue Service (the "IRS") to exercise the regulatory authority granted by section 1092(d)(3)(B)(i)(n). We further believe that the exercise of such regulatory authority in the March Regulation and the Proposed Regulation, taken in conjunction with section 1.246-5(c)(7), means that an equity swap and actively traded stock that economically are offsetting positions to each other constitute a straddle.

2. The mode of analysis employed by the Proposed Regulation - in particular, its interpretation of the second sentence of section 1092(d)(3)(A) - is strained. Nonetheless, this approach yields important correlative benefits, especially in enabling the IRS to reach the appropriate result that a termination payment in respect of an equity swap contract on actively traded stock gives rise to capital gain or loss under section 1234A, regardless of whether or not the swap (or, in the case of a compound swap<sup>10</sup>, each leg thereof) is part of a straddle. However, because the IRS and taxpayers generally did not consider equity swap termination payments to give rise to capital gain or loss prior to the promulgation of the Proposed Regulation, the final regulation should provide that its interpretation of the second sentence of section 1092(d)(3)(A) is effective only for positions entered into after May 2, 1995 (the date the Proposed Regulation was published in the Federal Register).

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<sup>10</sup> A compound swap is a contract providing that one party pays the total return on a notional investment in a specified equity and the counterparty pays the notional return on a different specified equity.

3. We generally agree with the adoption of the SSRP standard contained in the DRD regulations. The Treasury and the IRS should provide guidance as to what constitutes a "substantial diminution of the taxpayer's risk of loss" under section 1092(c)(1), which should be similar to the DRD risk diminution standard.

4. With respect to the effective date, the Treasury and the IRS should (i) clarify that the Proposed Regulation will apply only prospectively (i.e., after this clarification is announced) to a straddle that is entered into in respect of stock acquired by the taxpayer prior to January 1, 1984, (ii) correct a glitch in the Proposed Regulation that may prevent the general exercise of regulatory authority from being effective March 17, 1995 and (iii) make the interpretation of the second sentence of section 1092(d)(3)(A) effective only for positions entered into after May 2, 1995.

5. Now that the Treasury and the IRS have exercised the regulatory authority granted under section 1092(d)(3)(B)(i)(U), they should provide the necessary guidance regarding the application of the substantive straddle rules to equity straddle strategies and on the taxation of equity swaps generally. Issues on which guidance is needed include the following:

a. Where an equity swap is part of a straddle, what is the technical basis under which a payment made under the swap in respect of appreciation or depreciation in the underlying stock (a "principal payment") is subject to deferral until gain is recognized on the offsetting position? Is the payment a "loss" within the meaning of section 1092(a) and Regulations section 1.1092(b)- 5T(d) because the principal payment is described in section 1234A (see paragraph b. below)? If not, is it nonetheless a "loss" within the meaning of section 1092(a), notwithstanding that the payment arguably would be a deductible expense under section 162 (or section 212) whereas section 1.1092- 5T(d) defines "loss" as a loss otherwise allowable under section 165(a)? Is the principal payment instead subject to capitalization under section 263(g) and, if so, under which provision thereof?

b. Is a principal payment under an equity swap a "termination" of "a right or obligation with respect to personal property (as defined in section 1092(d)(1))" that is a capital asset, so as to give rise to capital gain or loss under section 1234A? Does it make a difference whether principal payments are made (only) at maturity of the swap or periodically during the term of the swap?

c. What is the scope of section 263(g) and how does it apply to various payments made or received in connection with equity swaps that are part of a straddle? Relevant issues include (i) whether net payments made under a swap in respect of interest on the notional principal amount or dividends on the underlying stock ("current return payments") are subject to capitalization under section 263(g) and if so, on what technical basis, (ii) the meaning of "incurred or continued to purchase or carry the personal property," as those terms are used in section 263(g), (iii) whether net current return payments received under a swap can be taken into account under section 263(g)(2)(B) to reduce the amount of interest and other carrying charges that are subject to capitalization, and (iv) whether interest, dividend or other income earned on collateral that is pledged to support indebtedness incurred to purchase or carry a position in a straddle can be taken into account under section 263(g)(2)(B).

d. What rules apply for the identification and matching of offsetting positions for purposes of the various substantive straddle rules (including the loss deferral rule, the holding period and character rules and section 263(g)) where a position offsets only a portion of an offsetting position? The absence of any guidance on this question under section

1092(c)(2)(B) means that taxpayers often are unable to enter into economic hedges of their stock positions without risking potentially severe adverse tax consequences.

e. Under Regulations section 1.446-3, when are nonperiodic principal payments (e.g.. the case of a swap providing for principal payments to be made only at maturity) taken into account? f. How do the various substantive straddle rules apply to compound swaps, straddles involving a portfolio position and a basket of stocks (as described in Regulations section 1.246-5(c)(1)(ii)) and straddles involving multistock, nonportfolio positions (as described in Regulations section 1.246-5(c)(v)?

In addition to the foregoing:

g. The Treasury and the IRS should promptly issue (and, in the interim, should announce that they will issue) regulations under section 1258(b) that will be retroactive and will provide that actual dividends as well as current return payments received in connection with a transaction consisting of an equity swap and an offsetting long stock position (as well as any amounts capitalized under section 263(g)) reduce the amount of capital gain subject to recharacterization under section 1258.

h. The Treasury and the IRS should confirm that the holding period termination rule of Regulations section 1.1092(b)-2T(a) is inapplicable for purposes of the DRD holding period. As set forth in the NYSBA Report, we believe this conclusion should be obvious.

Until guidance is provided on the foregoing issues, taxpayers will face considerable uncertainty given the extension of the straddle rules to equity swap straddles and other equity straddle strategies. Some of these issues are common to other straddle situations. However, since there are many more investors in stocks (including mutual funds, insurance companies and individuals) that routinely engage in economically motivated risk reduction strategies (as compared to investors in commodities, debt securities or other actively traded property), the universe of taxpayers potentially affected by the absence of guidance in this area has grown significantly as a result of the March Regulation and the Proposed Regulation.



#### **IV. COMMENTS REGARDING THE PROPOSED REGULATION.**

##### **A. Exercise of Regulatory Authority.**

It is appropriate for the Treasury and the IRS to exercise the regulatory authority granted by section 1092(d)(3)(B)(i)(II), as they have done in the March Regulation and the Proposed Regulation. When Congress amended section 1092 in the Tax Reform Act of 1984 (the "1984 Act") to grant such regulatory authority, it recognized that stock-related transactions could be utilized as straddle devices. Two such situations were identified in the legislative history, which indicates that the regulations relating to those situations, when issued, were to be effective as of March 1, 1984.<sup>11</sup> Other situations involving stock and an offsetting position in SSRP (other than stock) were to be covered prospectively under the regulations. In the ensuing years, the introduction and increased availability of a broad range of derivative contracts involving stock, including forward contracts and equity swaps, have made it easier for taxpayers to construct stock-related economic straddles.

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<sup>11</sup> The legislative history provides that a straddle consisting of stock and SSRP includes (i) offsetting positions consisting of stock and a convertible debenture of the same corporation where the price movements of the two positions are related and (ii) a short position in a stock index regulated futures contract ("RFC") (or alternatively an option on such an RFC or an option on the stock index) and stock in an investment company whose principal holdings mimic the performance of the stocks included in the stock index (or alternatively a portfolio of stocks whose performance mimics the performance of the stocks included in the index). H.R. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 908 (1984). The March Regulation and the Proposed Regulation follow the legislative history in adopting a March 1, 1984 effective date for these two situations. Regulations section 1.1092(d)-2(b)(2); Proposed Regulations section 1.1092(d)-2(e)(2)(ii).

We believe that the exercise of such regulatory authority in the March Regulation and the Proposed Regulation, taken in conjunction with Regulations section 1.246- 5(c)(7), means that an equity swap and actively traded stock that are offsetting positions to each other constitute a straddle. We support this result. Some taxpayers have contended that there is no regulatory authority to subject equity swaps to the straddle rules because section 1092(d)(3)(B)(i)(II) requires that the position be "with respect to substantially similar or related property (other than stock)" (emphasis added), and equity swaps constitute a position with respect to stock.<sup>12</sup> However, this argument should fail for the following reasons:

1. The legislative history of the 1984 Act indicates that this provision was intended to cover, inter alia, a convertible debenture, which clearly is a position with respect to stock, if the position in the debenture offsets a position in stock of the same corporation.<sup>13</sup>

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<sup>12</sup> It has also been suggested that an equity swap cannot constitute a "position" because neither it nor (as a result of section 1092(d)(3)(A)) the underlying stock is of a type which is actively traded. This argument, however, overlooks section 1092(d)(3)(C)(i), which provides that section 1092(d)(3)(B) is to be applied as if the stock were actively traded personal property, and which undoubtedly was intended to enable the straddle rules to be extended to positions in actively-traded stock and non-traded offsetting positions. As a result, as discussed in footnote 21 and the accompanying text below, an equity swap can indeed constitute an offsetting straddle position to stock. Additionally, it has been argued that the legislative history described in footnote 15 and the accompanying text, below, supports a narrower interpretation of the scope of regulatory authority, and that equity swaps that are offsetting positions to stock should be treated in the same manner as short sales that are offsetting positions to stock given their functional equivalence.

<sup>13</sup> See H.R. Conf. Rep. No. 98-861, 98th Cong. 2d Sess. 908 (1984).

2. The drafters of the straddle rules clearly understood that a futures contract, forward contract or other interest can constitute, at the same time, both an interest in the underlying property and an interest in property that is separate and distinct from the underlying property (i.e.. an ownership interest in the contract or other interest itself).<sup>14</sup> Thus, an equity swap can constitute a position with respect to SSRP that is not stock (i.e.. the swap itself), in addition to constituting a position with respect to the stock.

3. The legislative history of the 1984 Act indicates that Congress intended that the straddle rules be expanded, under regulations, but that they nonetheless not apply to the direct ownership of stock and the short sale of stock (because Congress was persuaded that such strategies involving actual stock were adequately covered by sections 1091 and 1233).<sup>15</sup>

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<sup>14</sup> See Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981. at 289 (1981) ("[A] futures contract, forward contract, option (other than a stock option) or other interest, while constituting a position in other property, is also personal property as defined in the Act if it is actively traded.")

<sup>15</sup> Prior to the 1984 Act, positions in stock effectively were not subject to the straddle rules. The amendments made by the 1984 Act represented a compromise between an expansive House bill and a narrow Senate bill. See H.R. Rep. No. 432, Part 2, 98<sup>th</sup> Cong. 2d Sess. 1268 (1984) (expanding straddle rules to all stock straddles other than a straddle all of the positions of which consist of the holding of stock or the short sale of stock); H.R. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 905, 907 (1984) (describing Senate amendment as expanding straddle rules only to straddles consisting of stock and stock options, and conference agreement, providing regulatory authority with respect to positions in SSRP other than stock, as being a compromise between House bill's expansive rule and Senate amendment's narrower approach).

In view of the foregoing, the most plausible interpretation of the parenthetical "(other than stock)" appears to be the one adopted in the Proposed Regulation – that it excludes direct ownership of stock or a short sale of stock but includes any other position with respect to SSRP. In any event, we believe that the IRS\* interpretation of the broad grant of regulatory authority as enabling the IRS to extend the straddle rules to straddles involving stock and equity swaps reasonably comports with the overall purpose of section 1092.<sup>16</sup>

**B. Mode of Analysis.**

While we support the Proposed Regulation's conclusion that equity swaps and actively traded stock that are offsetting positions with respect to each other constitute a straddle, the Proposed Regulation's mode of analysis – in particular, its interpretation of the second sentence of section 1092(d)(3)(A) – is strained.

Section 1092(d)(3)(A) states that, "Except as provided in subparagraph (B), the term "personal property" does not include stock." The provision then continues, "The preceding sentence shall not apply to any interest in stock."

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<sup>16</sup> Cf. Wetzler, "The Tax Treatment of Securities Transactions Under the Tax Reform Act of 1984", 25 Tax Notes 453, 458 (1984) ("Presumably such regulations can deal with new products or trading strategies that may have tax straddling potential."). As a senior staff member on the Joint Committee of Taxation, Wetzler was one of the principal drafters of the straddle rule provisions in 1981 and 1984.

A straightforward reading of the second quoted sentence is that it clarifies that although stock itself generally is excluded from the term "personal property", this exclusion does not apply to any interest in stock, such as an option or a forward contract, and that therefore such interests can constitute "personal property" if they are of a type that is actively traded. This straightforward reading also appears to be supported by the legislative history of this provision. The second sentence of section 1092(d)(3)(A) was added by the Tax Reform Act of 1986 (the "1986 Act") as a technical correction which "clarifies that the exception for stock does not operate to exempt straddles involving exchange traded stock options..."<sup>17</sup>

The Proposed Regulation, however, interprets the second sentence of section 1092(d)(3)(A) as setting forth a substantive rule to the effect that actively traded stock is "personal property" for purposes of testing whether an interest in the stock is a position with respect to personal property. Thus, under the Proposed Regulation, an equity swap on actively traded stock is a position with respect to personal property. This interpretation is difficult in the following respects: 1. It is a strained reading of the sentence, because the sentence itself says nothing about stock being personal property, and such an inference is not suggested by either the words or the context of the sentence.

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<sup>17</sup> Joint Committee on Taxation, General Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation. 99th Cong., 2d Sess., at 44 (1986). This technical correction to section 1092(d)(3)(A) also overturns legislatively the decision in *Maria Rivera*. 89 T.C. 343 (1987), in which the Tax Court, in an opinion that was widely questioned, held that, under pre-1984 Act section 1092, a stock forward contract is not a position in personal property within the meaning of section 1092(d)(2) because section 1092(d)(1) excludes stock altogether from the definition of personal property.

2. It goes well beyond what is suggested by the legislative history which, consistent with the straight forward reading of the sentence, indicates that the sentence was intended merely to clarify that the exception for stock contained in the preceding sentence does not extend to interests in stock that themselves are actively traded (such as, in particular, exchange traded stock options).

3. If the interpretation set forth in the Proposed Regulation is correct, then since 1984 the rule has been that a termination payment in respect of an equity swap on actively traded stock gives rise to capital gain or loss under section 1234A.<sup>18</sup> The Treasury had, however, previously reserved on the character of equity swap 10 termination payments and the scope of section 1234A.<sup>19</sup> Moreover, commentators had concluded - properly in our view - that, since stock generally was not "personal property" (prior to the March Regulation) and since equity swaps are not screen-traded and therefore are not of a type of property that is actively traded, the termination of a single-stock equity swap is not within the scope of section 1234A and therefore gives rise to ordinary income or loss.<sup>20</sup>

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<sup>18</sup> Section 1234A treats gain or loss attributable to the termination of "a right or obligation with respect to personal property (as defined in section 1092(d)(1))" as capital gain or loss.

<sup>19</sup> The Preamble to Regulations section 1.446-3, T.D. 8461, 1993-2 C.B. 215, 216 states that w[n]othing in the regulations supports characterizing either periodic or nonperiodic payments as attributable to the settlement, exercise, cancellation, lapse, expiration, or other termination of forward or option contracts."

<sup>20</sup> See Reinhold, "Tax Issues in Equity Swap Transactions," 57 Tax Notes 1185, 1198-99 (Nov. 23, 1992); Kleinbard, "Equity Derivative Products: Financial Innovation's Newest Challenge to the Tax System," 69 Texas L. Rev. 1319, 1341-46 (contrasting the treatment of an equity index swap on an actively traded stock index).

It would therefore be a considerable departure from earlier thinking to now maintain that an equity swap on actively traded stock was always a position with respect to personal property within the meaning of section 1092(d)(1).

4. Equally surprising, if this interpretation is correct, is that it would also be the case that since 1984 two offsetting equity swaps (each with a different counterparty) constitute a straddle under section 1092. Again, this was not understood to be the rule.

5. Section 1092(d)(3)(C)(i) contains a rule for treating actively traded stock as personal property for purposes of testing whether the conditions of section 1092(d) are satisfied, but states that this rule applies only for purposes of section 1092(d)(3)(B), not section 1092(d)(3)(A).

6. In fact, as a result of section 1092(d)(3)(C)(i), the exercise of regulatory authority under section 1092(d)(3)(B)(i)(n), and the Proposed Regulation's reasonable interpretation of the parenthetical "(other than stock)" in section 1092(d)(3)(B)(i)(T1), a straddle involving actively traded stock and an equity swap is subject to section 1092 even without the strained interpretation of the second sentence of section 1092(d)(3)(A).<sup>21</sup>

Notwithstanding the foregoing weaknesses, we believe that the Proposed Regulation's interpretation of the second sentence of section 1092(d)(3)(A) is not so unreasonable as to be indefensible.

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<sup>21</sup> The analysis would be:

1. Under section 1092(d)(3)(C)(i), the stock is treated as if it is "personal property" for purposes of testing whether the swap is an "offsetting position."
2. The equity swap is properly viewed as both an interest in the underlying stock and an interest in property that is separate and distinct from the underlying stock (i.e., an ownership interest in the swap itself) (see footnote 14 and the accompanying text, above).
3. Viewed as an interest in the underlying stock, the swap constitutes an interest in "personal property" by virtue of section 1092(d)(3)(C)(i) and therefore constitutes a "position."
4. Viewed as an interest in property that is separate and distinct from the stock, the swap is non-traded property that is SSRP with respect to the stock but is "other than stock" (because it is not direct ownership of stock or a short sale of stock).
5. In view of points 3 and 4, the swap is a "position with respect to SSRP (other than stock)."
6. 6. The stock is therefore treated as "personal property" (without further reliance on section 1092(d)(3)(C)(i)) because it is part of a straddle at least one of the offsetting positions of which is a position with respect to SSRP (other than stock).



Moreover, this interpretation enables the IRS to reach the appropriate result that a termination payment in respect of an equity swap contract on actively traded stock gives rise to capital gain or loss under section 1234A, regardless of whether or not the swap (or, in the case of a compound swap, each leg thereof) is part of a straddle.<sup>22</sup>

Also, as a result of this interpretation, equity swaps on actively traded stock that are offsetting positions with respect to each other will constitute a straddle. Accordingly, while we find the interpretation strained, we believe its merits outweigh its defects.

We recommend, however, that the final regulation explicitly set forth this interpretation of the second sentence of section 1092(d)(3)(A) as a substantive rule, instead of merely including it as part of the analysis in the example. In addition, given the novelty of this interpretation, we believe that this rule should be effective only for positions entered into after May 2, 1995 (the date the Proposed Regulation was published in the Federal Register), and that the final regulation should so provide. Thus, termination payments in respect of equity swaps would give rise to capital gain or loss

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<sup>22</sup> The significance of this appropriate result, of course, will depend on whether section 1234A is interpreted broadly so as to treat principal payments under an equity swap as a termination payment for purposes of section 1234A or, instead, is interpreted narrowly so as to treat as termination payments under section 1234A only a payment made or received to extinguish the remaining rights and obligations of a party under the swap. As noted in Part III .5.a. and b. above, guidance is needed on this important issue. If regulations were to adopt the analysis set forth in footnote 21 and the accompanying text, above, rather than the Proposed Regulation's interpretation of the second sentence of section 1092(d)(3)(A), it may still be feasible to arrive at an appropriate result under section 1234A through a regulation promulgated under that section. However, as indicated in the next sentence in the text, it does not appear to be feasible under the analysis set forth in footnote 21 to conclude that offsetting equity swaps constitute a straddle.

only for positions entered into after that date. However, equity swaps would be subject to the straddle rules as of the effective date of the March Regulation under the analysis set forth in footnote 21 and the accompanying text.

C. The SSRP Standard and Risk Diminution.

The Proposed Regulation incorporates by reference the SSRP standard set forth in Regulations section 1.246-5 (dealing with the DRD), with two minor variations. Under Regulations section 1.246-5(b)(1), property is SSRP with respect to stock if (i) the fair market values of the stock and the property primarily reflect the performance of a single enterprise, the same industry or industries, or the same economic factor or factors (such as, but not limited to, interest rates, commodity prices or foreign currency exchange rates), and (ii) changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes to the fair market value of the property. Section 1.246-5(b)(2) provides that, for purposes of the DRD, a taxpayer has diminished its risk of loss on its stock by holding positions with respect to SSRP if changes in the fair market values of the stock and the positions are reasonably expected to vary inversely. The Proposed Regulation (and the March Regulation) adopt the SSRP standard of Regulations section 1.246-5(b)(1) but do not adopt the diminished risk of loss standard of Regulations section 1.246-5(b)(2).

The DRD rules focus on whether the taxpayer has diminished its risk of loss on its stock that it owns by holding positions in SSRP (i.e.. a unilateral view), whereas the straddle rules focus on whether the taxpayer has substantially diminished its risk of loss on either the stock or the offsetting positions in SSRP (i.e.. a semi-bilateral view).<sup>23</sup> Subject to this difference in focus, the SSRP standard. in Regulations section 1.246-5(b)(1) should generally be serviceable for purposes of the straddle rules.<sup>24</sup>

The straddle rules, in section 1092(c)(1), contain a risk diminution standard that differs from the DRD risk diminution standard in that (i) it is semi-bilateral and (ii) it requires "a substantial diminution of the taxpayer's risk of loss." It would appear that, subject to these differences, the straddle risk diminution standard should be similar to the DRD risk diminution standard.<sup>25</sup> In any event, the Treasury and the IRS should provide guidance in this regard and, in particular, as to what constitutes a "substantial diminution" as opposed to just a "diminution."

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<sup>23</sup> The straddle rules do not adopt a fully bilateral view in that they do not require a substantial diminution in risk of loss on both positions. Thus, a person that holds stock and writes an at-the-money call option on that stock has established a straddle because the stock position diminishes the risk of loss on the call, even though the call does not diminish the risk of loss on the stock.

<sup>24</sup> Regulations section 1.246-5(b)(1)(ii) requires that changes in the fair market value of the stock be reasonably expected to approximate, directly or inversely, changes in the fair market value of the property.

<sup>25</sup> For example, section 1092(c)(3)(A), which contains presumptions for when two or more positions are treated as offsetting, provides that certain of these presumptions apply "only if the value of one or more such positions ordinarily varies inversely with the value of one or more other such presumptions."

Regulations section 1.246-5(c)(1) contains a special rule relating to stock portfolios and Regulations section 1.246-S(c)(7) contains a special rule for notional principal contracts. These provisions raise issues in the context of the straddle rules, which should be addressed in future guidance (see Part ELS, above).

The Proposed Regulation modifies the SSRP standard of the DRD rule in two minor respects. First, although for purposes of Regulations section 1.246-5, a "position" includes any interest in property or any contractual right to a payment, even if that interest or right is embedded in the stock or other property,<sup>26</sup> this rule is not carried over to section 1092,<sup>27</sup> presumably because positions that are embedded in a single instrument and hence cannot be traded separately are not susceptible to the sort of manipulation (i.e., disposing of one leg before the other) that the straddle rules are intended to prevent. We agree with this assessment.

Second, Proposed Regulation section 1.1092(d)-2(b) states that, "The rule in §1.246-5(c)(6) does not narrow the related party rule in section 1092(d)(4)." Section 1092(d)(4) treats a taxpayer as holding positions held by related persons for purposes of determining whether a straddle exists, and defines "related person" for this purpose as (i) the taxpayer's spouse, (ii) a member of an affiliated group filing a consolidated return with the taxpayer and (iii) in general, a partnership or other flow-through entity if part or all of the gain or loss with respect to a position held by it would be reportable by the taxpayer.

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<sup>26</sup> Regulations section 1.246-5(b)(3).

<sup>27</sup> Proposed Regulations section 1.1092(d)-2(b).

Regulations section 1.246-5(c)(6) treats a taxpayer as holding positions held by a related person (within the meaning of sections 267(b) or 707(b)(1)) or a pass-through entity, intermediary or other arrangement with a view to avoiding the application of the DRD regulation or the straddle regulation. In our view, Regulations section 1.246-5(c)(6) appropriately implements - for purposes of the DRD and stock straddle rules dealing with the diminution of risk relating to SSRP - the regulatory authority granted in section 7701(f), which authority to date the Treasury and the IRS have not exercised in any other context.<sup>28</sup>

#### D. Effective Date.

1. Straddles entered into on or after the effective date of the regulation in respect of previously acquired stock. In general, the Proposed Regulation "applies to positions established on or after May 1, 1995."<sup>29</sup> The example in Proposed Regulation section 1.1092(d)-2(d) involves an equity swap entered into on September 29, 1995 in respect of actively traded X stock that was acquired in 1990. Thus, the Proposed Regulation applies in respect of stock acquired prior to May 1, 1995 so long as the offsetting position is established on or after May 1, 1995. We assume that the Treasury and the IRS intend that the March Regulation be interpreted in a similar manner.

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<sup>28</sup> While the Tax Court's recent opinion in H Enterprises Inc. v. Commissioner, 105 T.C. No. 6 (July 31, 1995) indicates that a court might be willing to apply conduit-type principles in appropriate circumstances even in the absence of regulations under section 7701(f), it would appear to be easier to do so in the context of sections 265(a)(2) and 246A, which, as the Tax Court noted, do not by their terms require the borrower to be the same entity as the purchaser of the tax-exempt securities or the portfolio stock, than in the context of section 1092, which contains an explicit related person provision.

<sup>29</sup> Proposed Regulations section 1.1092(d)-2(e)(1).

2. Straddles in respect of stock acquired prior to 1984. The Treasury and the IRS should provide timely guidance clarifying the application of the Proposed Regulation to an equity swap (or other offsetting position) entered into on or after the effective date in respect of stock that was acquired by a taxpayer prior to January 1, 1984. While it might seem unusual for taxpayers to enter into equity swaps in respect of actively traded stock acquired more than eleven years ago, founding shareholders of privately held companies that either go public or are acquired by a public company in a tax-free reorganization might wish to enter into an equity swap in respect of that actively traded stock.

Section 1092(d)(3) is effective for "positions established after December 31, 1983 in taxable years ending after such date."<sup>30</sup> The language of the statutory effective date provision is similar to that of the Proposed Regulation (and the March Regulation). As discussed above, the effective date provision of the Proposed Regulation has been interpreted in the Proposed Regulation to require only that the offsetting position to the stock be entered into after the Proposed Regulation's effective date.

The Committee believes that it is reasonable for the Treasury and the IRS to interpret the parallel language of the effective date provision of section 1092(d)(3) in a similar manner, and that as a policy matter it is inappropriate to exclude from the straddle rules equity swaps (or other offsetting positions) entered into after the effective date of the Proposed Regulation in respect of stock that was acquired by the taxpayer prior to January 1, 1984.

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<sup>30</sup> Pub.L. 98-369, section 101(e)(1).

However, we also recognize that a reasonable leading of the statutory effective date provision is that both "positions" within the meaning of section 1092 (Lfi., both the stock position and the offsetting position) must be entered into after the effective date.<sup>31</sup> Under this reading of the effective date of section 1092(d)(3), Congress authorized the IRS and the Treasury to extend the straddle rules to offsetting positions in stock and SSRP only where the stock is acquired after December 31, 1983.<sup>32</sup> We understand that, in the eleven years since its enactment, taxpayers have in fact undertaken transactions and taken positions based on this interpretation of the statutory effective date provision of section 1092(d)(3).<sup>33</sup>

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<sup>31</sup> It is unclear what inferences, if any, should be drawn from previous effective date provisions relating to section 1092 as to whether the reference to "positions entered into" after the effective date is intended to cover both positions, or only the position that offsets the personal property and that creates the straddle. The Economic Recovery Tax Act of 1981 ("ERTA") made section 1092 effective "for property acquired and positions established by the taxpayer after June 23, 1981, in taxable years ending after that date." Pub.L. 97-34, section 508(a). (ERTA also contained an election permitting taxpayers to apply the amendments made by ERTA to all regulated futures contracts or positions held by the taxpayer on June 23, 1981.) On the other hand, a grandfather rule for pre-1982 straddles that was enacted as part of the 1984 Act (section 108 of Pub.L. 98-369) applies "in the case of any disposition of 1 or more positions ... which were entered into before 1982 and form part of a straddle ..."

<sup>32</sup> A possible alternative reading of the effective date provision is that even if both "positions" must be entered into after December 31, 1983, section 1092(d)(3) applies to stock acquired before 1984 because the stock is not a "position" (under section 1092(d)(3)(A)) until it is part of a straddle described in section 1092(d)(3)(B) and therefore both "positions" are entered into after December 31, 1983. This reading is arguably too subtle to expect taxpayers to have been fairly apprised that section 1092(d)(3) applies to stock acquired before 1984.

<sup>33</sup> Even prior to the March Regulation, the effective date was relevant for purposes of a straddle consisting of stock and an option with respect to such stock or substantially identical stock or securities, under section 1092(d)(3)(B)(i)(I).

In view of the foregoing, we recommend that the Treasury and the IRS exercise their authority to interpret the effective date provision of section 1092(d)(3) as requiring only that the offsetting position to the stock be entered into after December 31, 1983. However, given the considerations noted above, we believe that the final regulation should state that this interpretation is applicable only with respect to offsetting positions entered into after this interpretation is announced in a proposed regulation or other administrative pronouncement. We also believe that the final regulation should take no position as to the interpretation of the effective date provision during the period between enactment of the statute and the promulgation of such a proposed regulation or other administrative pronouncement.

3. **Equity swaps entered into between March 17 and May 1, 1995.** The preamble to the Proposed Regulations states that the IRS believes that the Proposed Regulation merely clarifies the rule that applies as of March 17, 1995, the effective date of the March Regulation. However, adoption of the Proposed Regulation in its present form may inadvertently result in deferring the effective date of the exercise of regulatory authority under section 1092(d)(3)(B)(i)(II) from March 17 to May 1. After setting forth the general May 1 effective date, Proposed Regulation section 1.1092(d)-2(e)(2) provides that "Paragraph (b) of this section [adopting the definition of SSRP from the DRD regulation] applies to positions established on or after March 17, 1995," This provision, however, has no operative effect since paragraph (b) does not actually exercise the regulatory authority under section 1092(d)(3)(B)(i)(II); instead, the regulatory authority is exercised under paragraph (a), which is subject to the May 1 general effective date. This glitch in the Proposed Regulation should be corrected.



4. The second sentence of section 1092(d)(3)(A). As noted above, the final regulation should provide that the Proposed Regulation's interpretation of the second sentence of section 1092(d)(3)(A) is effective only after May 2,1995.